UNFAIR FRANCHISE PRACTICES

HEARING

BEFORE THE

SUBCOMMITTEE ON ANTITRUST, IMPACT OF DEREGULATION, AND PRIVATIZATION

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

WASHINGTON, DC, AUGUST 4, 1988

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UNFAIR FRANCHISE PRACTICES

THURSDAY, AUGUST 4, 1988

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ANTITRUST, IMPACT OF
DEREGULATION, AND PRIVATIZATION,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:12 a.m., in room 2359–A, Rayburn House Office Building, Hon. Dennis E. Eckart (chairman of the subcommittee) presiding.

Present: Chairman Eckart; Representatives Price, Martinez, and Hiler.

Chairman ECKART. The Small Business Subcommittee on Antitrust, Impact of Deregulation, and Privatization hearing will come to order. I apologize to our guests and our witnesses because there is a series of votes that is going to take place this morning, and we will do the absolute best we can to make sure the business of the floor, which, of course, is important for all of us, does not inconvenience you.

It has been over 10 years, September 1977, since Congress last examined the franchisor/franchisee relationship which at the time prompted the introduction at that time of legislation protecting franchisees from unfair franchise practices. During the past 10 years the franchise industry has operated in a highly unregulated environment and has grown and blossomed. Unfortunately, some franchisees who operate these small businesses continue to raise some of the same concerns that Congress addressed more than one decade ago.

It is estimated in the franchise industry that by the year 2000, one-half of all retail sales in the United States will come through franchise operations, and almost 6 million people will be employed by franchise businesses. Thus, it is clear to this subcommittee and to the Members of Congress, that this is an area of great opportunity and growth. It is also an area of uncertainty which this subcommittee is interested in ascertaining the depth of.

Today's hearing will provide the subcommittee with an opportunity to examine this unique system of marketing goods and services which enable many people—many of whom have limited capital, a good product or idea—to take it to market. Throughout the past several years we have seen many of these good ideas dot the landscape from the smallest, most rural districts, to the heart of our downtown cities. Most of these new business opportunities, in fact, are operated by small businessmen and women with a desire, obviously, to be successful.

Because franchising is, as I mentioned, such a dynamic and large force in the marketplace, this subcommittee will focus only on the business format franchise, where goods or services are offered, sold, or distributed by the franchisee under a marketing format or system that is designed by the franchisor. This type of franchise includes fast food restaurants, nonfood retailing, motels, stores, car rental operations, and several service-related businesses, just to name a few.

This type of industry requires a unique and special relationship between the franchisor and the franchisee. From the very first evaluation of the franchise opportunity, to the disclosure and filing requirements, and the sometimes unfortunate termination or nonrenewal of a franchise, it is a system that is fraught with problems and filled with opportunities. Because franchising does play such a significant role in our economy, today's hearing will give our subcommittee and full committee an opportunity to hear firsthand some of the problems that may exist or are overlooked on a day-to-day basis.

Several of today's witnesses have been involved intimately in the operation and running of franchises. Several have studied them from an academic and theoretical perspective. I want to, in advance, thank all of them for coming to Washington to appear before our subcommittee, and I look forward to hearing your testimony.

Because of the peculiar constraints of today's session, I want to remind each of our witnesses that we hope to enable the subcommittee to continue irrespective of the roll call votes. But because I'm either blessed, or cursed, with a 100-percent voting record, I'm going to have to juggle very carefully to make sure that I don't drop down and go "O for 4" today, which in baseball parlance would be familiar to some.

So let me call first our first panel, Mr. John Jensen, president, Ren-Jack, Inc., a franchisee of Taco Bell Corp., Fresno, CA; Ms. Deborah Taylor, Esq., attorney-at-law, Texas and Georgia; Mr. Michael J. Wild, president, Re-De Equipment Corp., Brooklyn, NY, and he will be accompanied by Mitchell Kramer, Esq., general counsel for the Fair Franchising Coalition; and Mr. Neil Simon, counsel and director, Government Relations, International Franchise Association.

Again, I want to thank each of our witnesses. I apologize for the fact that we are commencing this during a roll call. Many of my colleagues are over on the floor doing what I went over there ahead of time to do.

I would remind each of the panel members that your entire statement will be included in the record in its entirety, and I would ask you to limit your oral testimony today to 5 minutes.

Our first witness is Mr. John Jensen, president, Ren-Jack, Inc., as I mentioned, a franchisee of Taco Bell Corp., Fresno, CA. Mr. Jensen, welcome. Proceed as you see fit.

TESTIMONY OF JOHN J. JENSEN, PRESIDENT, REN-JACK, INC.

Mr. JENSEN. I have a prepared statement that I think I can read in approximately 5 minutes. Is that satisfactory?

Chairman ECKART. Fire when ready.

Mr. JENSEN. All right. My name is Jack Jensen. I would like to thank you for the opportunity to participate in this hearing regarding the business format segment of the franchise industry.

My brother Reynolds and I are currently Taco Bell franchisees in Fresno, CA. For anyone who might not be aware, Taco Bell is a member of the PepsiCo family of restaurants, which also includes Pizza Hut and most recently acquired Kentucky Fried Chicken. Taco Bell has approximately 2,700 Mexican quick-service restaurants, of which approximately 1,500 are company owned and 1,200 are franchised.

My brother originally worked for Glen Bell, who founded Taco Bell. In 1965 he worked as a franchise consultant opening new restaurants while he was waiting for his first franchised unit to be built in Fresno. Prior to becoming a Taco Bell franchisee, I had been a multiunit independent tire dealer in the Ann Arbor-Detroit, MI, area for the previous 16 years. I joined my brother in 1981 at a time when he had increased from one unit to five.

My brother and I had kept in close contact throughout the years and he had determined that the atmosphere and the timing was right to become very aggressive and open new units as fast as possible, so that we could become the dominant Mexican quick-service restaurant in our area of dominant influence. We had envisioned that 20 to 25 units would accomplish this goal. With that vision in mind, I proceeded to dispose of my business interests in Michigan and prepared to relocate in Fresno.

We approached Taco Bell with our plans and were enthusiastically encouraged to proceed. I submitted my application and financial information and was accepted into the franchise community.

We immediately proceeded to secure property and by April 1982 opened our first joint unit, the next in July 1982, and our third in September 1982. Our plan was well underway—1983 proceeded well, with the opening of three additional units, as well as the same in 1984.

However, the relationship was becoming more strained because of the increasing demands being placed upon us from the corporation. The demands were in the form of equipment and decor changes in existing restaurants before we would be favored with another unit. In some cases it grew to $1 million of upgrades to obtain one more unit. In a 12-month period between 1984 and 1985, our upgrading expenditures approximated $800,000.

Another common tactic that was being used was for the franchise consultant to do shoppers' reports on a few units and give them failing scores, thus rendering us operationally unapproved for growth. However, once you complied with the shopping list of upgrades, we would become operationally more proficient and then favored with one more unit.

At the end of 1984, the company determined that it would be in the best interest of the system to institute a new fee restructure policy that was far more favorable to the company and less favorable to the franchisee. At this point we had several different agreements in effect. However, in all cases, the terms did not seem to be in our best interest. This was the beginning of a long period of hos-

tility between the corporation and us, as well as other franchisees and corporation.

We had three more units that were ready to break ground and were informed that since we had not committed to the new marketing plan, no new restaurants would be forthcoming. The proceeding months became a real nightmare of negotiating while getting legal counsel involved.

Apparently, when a franchisee looks to outside assistance from legal counsel, you have committed a form of "hari kiri," much the same as when the news gets back to the corporation that I'm participating in this exercise today.

After several months of soul searching, we chose to dismiss our legal counsel and try to come to terms with a program that was somewhat reasonable without giving away the farm. On March 17, 1985, we met with the powers that be at the corporation and proceeded to negotiate what we felt was reasonable at the time. Mind you, there was extreme pressure being placed upon corporate personnel to bring all nonconforming franchisees into line.

We agreed to amend all of our contracts in exchange for the immediate approval of the three units that were in place, plus five additional units, and the assistance of the corporation in changing the voting structure within our advertising association to better reflect our contribution, which at that time was approximately 70 percent of the funds. We were only asking to make it commensurate with the voting rights that the corporation has in the geographical areas in which they are the predominant contributors.

After signing the fee restructure agreements, we immediately began construction on the three units and proceeded as orally agreed. In fact, at this point in time Fresno was the only major market in the Nation where there were more Taco Bell restaurants than McDonald's. Within 90 days, all that had been orally agreed to was now a commitment that was not to be honored.

Once again, we went back to legal counsel and a long period of frustration. It was also at a time that one of our supervisors was sold a franchise to open a unit at a location that was part of our plan, and the entry of another new franchisee into the system opening on two additional locations that were also in our plan. It seemed that now we were put in a position that the outside competition was not our greatest fear; it was the fear of having to protect ourselves from the people we send $20,000 a week to for the privilege of being a Taco Bell franchisee.

Concurrently at this time an organization named the National Association of Taco Bell Franchisees was being revived because of mounting problems within the franchise community. In search of a forum in which we could have some input into improprieties that were occurring, we chose to get involved. At the next national meeting I was elected vice president. Shortly after that the president incurred life-threatening health problems and had to resign, therefore elevating me to president, of which I have since been reelected. However, again, this is a forum that the Taco Bell Corp. will not recognize or communicate with.

The concerns of the NATBF were that of cannibalization, forced expansion, renewals, and forced equipment purchases. I addressed these concerns to John Martin, president of Taco Bell, in a letter in

May 1987. The letter had been constructed by a committee of franchisees and NATBF's legal counsel.

In response, I received a short, two-paragraph letter from Taco Bell's general counsel stating that our concerns were unfounded and they were considered as bald acts of treachery. As a member of the national association, I had been labeled a dissident, saber rattler, and rabble rouser, just to name a few.

I must digress for a few moments to touch on another area of concern by your subcommittee, and that is of renewals. We had increased operations to 18 units, but because of nonrenewals, we have decreased to 17 units and soon to be 16 units in the Fresno, CA area.

In April 1986, Taco Bell forced us to close the first unit that my brother had opened in 1966. This occurred after we had amended our agreements and increased the fees in this unit from 2 percent weekly to 10 percent weekly. A renewal was offered to us; however, it was offered with the stipulation that we had to build a new current Taco Bell restaurant on this same location. No alternatives were given. We could not comply as the square footage of the lot was a mere 16,000 feet. To construct a building of the current design, it requires a minimum of 28,000 square feet, and works best with 32,000 to 35,000 square feet.

That restaurant in its last full year of operation netted in excess of $100,000 and was well above the national average in sales. There is also a side note, that it was 1½ years after the closing before we received the $4,500 noninterest bearing deposit that had been made back in 1965.

Now, coming to August 1988, the second unit is being closed on August 30, 1988. No successor agreement has been offered, nor has any letter of explanation been forthcoming as to why it is being closed, nor has any alternate location been offered.

I have been informed by a source very close to the president of Taco Bell that we will never get another unit, another renewal, nor would we get favorable consideration should we attempt to sell. This is probably fact, as this has happened to other franchisees that I have been in contact with through NATBF.

This puts the franchisee in a position of owning a diminishing asset without being able to sell on the open market. This is a result of the corporation maintaining the right to disapprove any potential buyer a franchisee may present, without giving a reason for that disapproval.

Also to be considered is the fact that there are noncompeting clauses in the agreements which preclude a person from entering into any kind of quick service restaurant that in any way would compete with Taco Bell. However, the same consideration does not prevail within the PepsiCo organization, as they have, as reported in the most recent annual report, 13,000 Pizza Hut and Kentucky Fried Chicken units that most definitely compete with Taco Bell for the fast food dollar.

I thank you for the opportunity to present an individual franchisee's situation in dealing with the mega conglomerate franchisor. I have volumes of pages of documentation and correspondence to substantiate these statements, as well as the claims of other

franchisees who have shared and confided in me with their problems.

Should the direction of your subcommittee have the need to be more specific, please feel free to contact me. If anyone should have any questions, I am open at this time.

[Mr. Jensen's statement may be found in the appendix.]

Chairman ECKART. Thank you, Mr. Jensen. Generally, our practice is to hear from the entire panel first, and then ask a series of questions.

Ms. Taylor.

TESTIMONY OF DEBORAH TAYLOR, ESQ., ATTORNEY-AT-LAW

Ms. TAYLOR. Good morning. My name is Deborah Taylor and I'm an attorney. My practice is devoted to representing franchisees almost exclusively and their many problems. I could sit here all day and talk about the problems that occur. I will try to cut it down to 5 minutes.

First I would like to thank this subcommittee for looking into this problem. It's a problem that every day has an impact on families across the country and in every State. It's a very serious problem. Franchisees do not have the funds, do not have the infrastructure and organization, to present a case in Washington at this time. I believe that's going to change in the future. I want to thank the subcommittee for looking at this from both sides, and I would certainly encourage any future hearings or actions that can be taken in this regard.

Most of the franchisees that I represent are what I call the lower-end franchisees. That is, someone who perhaps it costs $200,000 or less to get into the franchise. Now, there are other franchises, of course, that may cost several million dollars. Those individuals, or a consortium of individuals, who are buying those larger or higher-end franchises have access to a committee of lawyers, just as the franchisor may have, and there is equal bargaining power and negotiation on both sides. These larger-end franchisees also have problems. However, the lower-end franchise makes up by far the majority of franchises in this country.

These individuals are people who take out a second mortgage on their home, use up the entire equity they have in their house, and commit their life savings. The wife quits her job, and basically they open up a mom and pop shop somewhere. Whether it's selling printing services, whether it's hamburgers, whether you're selling flowers, it doesn't matter.

Generally, for this entire investment and for the risk that they take, they get 2 or 3 weeks' worth of training at the franchisor headquarters. They get operation manuals which very often consist of photocopies of publications put out by the Small Business Administration. These manuals are called trade secrets and in most franchise agreements, which the franchisee signs, the franchisee is acknowledging that he, in fact, is receiving trade secrets from the franchisor. This is a very common practice.

There are many things that can go wrong in the relationship. I want to mention at this moment that even in these lower-end franchises, many individuals make a good living and many times both

sides mutually profit from the relationship. There are many people who come into my office who are very grateful to the franchisor. However, we have another problem, and that is the franchisees in this country who stand to lose and have lost everything they own.

I would just like to bring out three scenarios, very quickly. In the first two scenarios I will assume a successful franchise; that is, when the franchisee is able to make a very good living, say between $50,000 and $70,000 a year. Perhaps his wife takes an additional $10,000–$15,000 a year out of the business.

In the first case, the franchisee bought into the franchise, he risked the equity in his house and his savings. He worked 60 or 70 hours a week. He wife worked another 40 hours a week. His two children come in and work in the business after school 2 or 3 days a week. At the end of the 10-year license, or the 10-year contract, the franchisor determines that in a certain area of the country the franchisees have, indeed, made a success of the business. Perhaps that area of the country is particularly susceptible or particularly desirous for the product or service that's being offered. Therefore, the franchise is not renewed.

In that case the franchisee is left without his business and stuck with a covenant not to compete. That is the clause which is found in almost every franchise agreement that states, upon termination of the relationship, the franchisee may not work in that business within 50 miles from his location for a 2-year period. So not only is the franchisor able to take over the location, either to run for the franchisor's own profit or to resell for several hundreds of thousands of dollars, because it's a profitable business, but the franchisee is deprived of his very skill and the very talent and knowledge that he has been able to develop over the past 10 or 15 years. This is a very, very big problem.

The franchisor can do this by another method. Many franchise agreements will say that the franchisee does have a right to renew. However, the franchisee must sign the then current franchise form. There are cases, when it comes time to renew the license, the royalty will escalate, say, from $12,000 a year or $20,000 a year up to $78,000 a year, essentially divesting the franchisee of his profits from his livelihood.

However, the franchisee is caught in a very sticky position. On the one hand, he can renew and turn a majority of his profits over to the franchisor through the raised royalty rate, or, if he doesn't renew, he is stuck with a covenant not to compete and he has to go out of business all together. This is something that is occurring more and more frequently. Franchising became a very popular way to do business 20 years ago, and now many of these licenses are up for renewal, since they were 20-year agreements.

To move on very quickly with another scenario, there is a successful franchise. It's become successful all over the country. Why? Because the franchisees have developed the way to conduct the business. They started off with a business, were given operating manuals which consisted of photocopies of SBA printouts, or perhaps photocopies of college accounting manuals. They learned how to build the business from the ground up. The product becomes well known in the country. The trademark becomes well known in the country.

I want to point out that in many product franchises there is a trademark which the public associates with a product, although, in fact, the origin of the product may come from various areas. The franchisor decides that this product, now that it has a well-known and accepted trademark, can be distributed through what we call alternate retail channels. That is, the product can now be sold through supermarkets and through department stores. The small franchisee cannot compete with those kinds of economics. Department stores, because they are large stores, get a better break in their rent in malls, where the franchisee is paying for premium retail space. The franchisee is just not able to compete.

Chairman ECKART. Ms. Taylor, if you could wrap it up, then John and I can go vote.

Ms. TAYLOR. I'm sorry. Let me just say that the third scenario is when there is fraud and when, in fact, the promises made to the franchisee are not forthcoming. One of the things that I really believe needs to be looked into is the Federal Arbitration Act. This act has perhaps presented the singlemost difficult obstacle to franchisees in addressing these issues. The franchisee often cannot afford arbitration. Even though arbitration is supposed to be a faster and less costly method, it often is not.

I know I have run over my time, so I will wrap it up with that comment.

Chairman ECKART. I have a series of questions about arbitration, but if I could ask Mr. Wild and Mr. Simon to hold for a second while John and I go vote, you'll have a good sense of what kind of shape we're in and see how fast it takes us to go over and back.

We are in recess.

[Whereupon, the subcommittee was in recess.]

Mr. PRICE [presiding]. We are now ready for your statement, Mr. Wild, and we are glad to see Mitchell Kramer accompanying you here. We will then we will hear from Mr. Simon.

The format we've been following, I understand, is to have you summarize your statement. Of course, we will reprint your full statement in the record.

Mr. Wild, please proceed.

TESTIMONY OF MICHAEL J. WILD, PRESIDENT, RE-DE EQUIPMENT CORP.; ACCOMPANIED BY MITCHELL KRAMER, ESQ., GENERAL COUNSEL, FAIR FRANCHISING COALITION

Mr. WILD. Thank you. Good morning.

I am Mike Wild, and I represent the Fair Franchising Coalition. I want to first thank the Chair and the members of the subcommittee for the opportunity to present our views before your subcommittee today.

I am president of Re-De Equipment, Inc., of Brooklyn, NY, and past president of our trade association, the Independent Medical Distributors Association. Accompanying me today is Mitchell Kramer, Esq., a Philadelphia attorney specializing in franchise law.

What I would like to do now, since time is limited, is leave my statement so that it can be entered into the record, and just take a moment or two to explain what we do and the problems that we are being confronted with in the marketplace.

We are a distributor. Unlike a franchise organization, as a distributor, we have contractual agreements with several different manufacturers to represent them in a specific geographical area. My company represents various medical equipment manufacturers and we primarily sell their equipment to the hospitals in the metropolitan New York City area.

We have been representing some of these companies for as long as 22 years, and we have contracts with these manufacturers that renew periodically, in some instances annually, in some instances on a 3-year basis. However, the problem that we find is that in almost all of these contracts that we have with these manufacturers, they have termination clauses entered into the contract.

Now, I certainly find no fault with termination clauses when they are for cause: That is to say, a particular distributor does not promote the product as he should, the particular distributor does not meet their quotas as mutually agreed upon, or the particular distributor is not prompt in paying the manufacturer for the goods that he has purchased from them.

The problem we have in the clause that we find in most of the contracts is that it says the manufacturer or distributor can terminate with 30-, 60-, or 90-days' notice without cause. My company, in the New York city area, has recently been terminated by a particular manufacturer without cause. This particular manufacturer has represented approximately 30 percent of my total corporate business. We have represented them for about 21 years and, in essence, my company became synonymous with the manufacturer in the metropolitan New York city area.

We were doing about $1.3 million a year worth of business with them. Lo and behold, one day Federal Express comes and leaves me this little letter that says, pursuant to paragraph such and such, we are terminating without cause on 90 days' notice. We, of course, tried to fight and tried to persuade the manufacturer to reconsider, but the only excuse, the only answer that we had from the manufacturer, was the fact that they were doing it for marketing purposes, and that they felt they could more effectively market on a direct basis in our geographic area than through the distributor. They wanted control.

We, of course, retorted by saying that we have consistently increased sales on an annual basis; that we have abided by all of their rules and regulations; that we have never been in arrears. They didn't want to hear anything about that.

Now, what happens after such an arbitrary termination to a company such as mine? The first thing that happens, of course, is that the manufacturer does not give you sufficient time so that you can actually readjust your corporation so that you can absorb the loss in some sort of a logical businesslike fashion. We were given 90 days. After 21 years, 90 days is not really sufficient time to restructure your corporation, when 30 percent of your total business revolves around this one manufacturer.

What has basically happened in my company since that fateful day in April was that we have seen a downward spiral. The downward spiral is caused by the fact that as soon as our sales people realized that they no longer had the product of this particular manufacturer, they realized they could not earn as much money as

they had in previous years and, therefore, they sought other employment. When my key sales people started to leave, other manufacturers that we represented looked at us and said, "Gee, what's happening to Re-De? It seems that they're losing their sales people. Perhaps we ought to look at other companies in that area to represent our product." So it creates a continual downward spiral, and if it's not stemmed, I could very shortly find myself out of business.

In order to stop this downward spiral, and in order to stay in business, we were forced to terminate the employment of several key people, people who were both good and loyal employees of the corporation and who, through no fault of their own, found themselves in a particular catch-22 position where they no longer could earn their living because of the arbitrary demand of the manufacturer to go on a direct sale basis.

The business is choked. The manufacturer refused to give termination protection in their original contracts. We have spoken to most of our manufacturers about this and basically what they're saying to the distributors—and not just to my company but to distributors as a whole—this is in our contract, and if you don't want to take our contract the way it is written, we'll find a dealer in a particular geographic area who is willing to take our contract. They really give you no choice in the matter. It leads to a tremendous problem. It leads to a problem where we have to really scurry about now to save the corporation.

It's interesting to note that in the 21 years that we've been in business we have had two major terminations of this type. It's interesting to note that both—and I really don't know if this is pertinent or not, but it's certainly an interesting aside—both of the corporations that opted to go from a distributor related basis to a direct sale basis were companies that had both been recently purchased by British corporations. One was British Oxygen and one was Vickers, who came in and purchased these two U.S. manufacturers. From what we can gather, they prefer to go on a direct sale basis, thereby putting in jeopardy most of the distributors that are handling these major medical equipment lines. So we find ourselves in this position. We find ourselves now trying to survive.

But we also find ourselves in a tremendous need for some sort of legislation that can help small companies such as myself. This is the reason that I feel that your subcommittee, and perhaps with the coalition of the other distributors in our group, we can try to persuade your subcommittee into giving us the protection that we seek and that we need so desperately in order for us to survive in our industry. We live in a very precarious area. We are precariously balanced between trying to successfully operate a multimillion dollar business on the one hand and, on the other hand, with the knowledge that termination can come at any time, for any reason, without any cause, without any reason, strictly on the whim of the manufacturer who, for whatever reason, feels that the relationship between his company and our company have continued for too long. I thank you for your time.

[Mr. Wild's statement may be found in the appendix.]

Mr. PRICE. Thank you, Mr. Wild.

Mr. Simon, please.

TESTIMONY OF NEIL SIMON, COUNSEL AND DIRECTOR OF GOVERNMENT RELATIONS, INTERNATIONAL FRANCHISE ASSOCIATION

Mr. SIMON. Good morning, Congressman Price.

My name is Neil Simon. I am counsel and director of government relations to the International Franchise Association, which is a Washington, DC-based trade association representing more than 650 business format franchisors. I will limit my comments before the subcommittee today to business format franchising.

The success of business format franchising—and it is extremely successful—lies in the careful balance of business interests. Franchisees remain independent business owners afforded an opportunity to enter a proven business and enjoy the advantages of being part of a larger system, and franchisors build the strength of their trademark and image through growth unavailable by conventional means of expansion and receive royalty income from their franchisees as the system grows.

Inasmuch as royalty income, with very rare exception, is based on the franchisee's gross sales, the franchisor profits only if its franchisees are, in turn, are successful. This balance which I have just described is struck in a contract, signed by both the franchisor and the franchisee, which sets forth their respective rights and obligations. Franchisees will pay an initial franchise fee—the amount varying greatly among business in the more than 40 different industries that use franchising as a means of distributing a good or service—and they will pay monthly royalties, as I mentioned.

In turn, the franchisor establishes a fully integrated relationship with the franchisee governing the product or service, use of the trademark, site selection, marketing strategy and plan, advertising, operating standards, and quality control. The franchisor will generally provide a comprehensive operating manual and a system for regular communication with the franchisee for the duration of the agreement, typically 15 to 20 years.

The terms of these contracts vary from one franchisor to the next, according to the design of the particular franchise system—and there is enormous variation. This adaptivity allows franchise systems to meet the demands of the marketplace and compete with large, vertically integrated chains, which are the threat to the survival of small business in this country today. Members of the International Franchise Association range from Hilton Hotels to Midas Muffler, from Century 21 Real Estate to McDonald's, from H&R Block to Pearle Optical Centers. Though these names may be familiar to you, the bulk of our members are small businesses themselves creating other small businesses. Forty percent of our almost 700 members have fewer than 25 franchised outlets and an additional one-quarter have fewer than 100 units.

The health of business format franchising is best reflected in data collected by the U.S. Department of Commerce, data, I might add, which is essential to the ability of public policy makers to continue to have a handle on what is happening in this thriving sector of our economy. This committee should be aware that "Franchising in the Economy," which is an annual survey that compiles this data, is threatened. The Office of Management and Budget has

called for a discontinuation of funding for this very important survey. I urge this subcommittee to recommend to this administration that its funding be maintained.

In any case, the Department of Commerce data regarding termination, nonrenewal, and transfer activity—which is the thing that has been addressed by other members of this panel today—are very telling. For the year 1986, of the 12,999 franchise agreements up for renewal, 93 percent were renewed; of those not renewed, 79 percent were at the initiative of the franchisee or by mutual consent.

Even more important, of the 244,000 franchisee-owned outlets in this country in 1986, only 3 percent were terminated. Again, a clear majority of those contracts terminated were at the initiative of the franchisee or by mutual consent.

Last, 98 percent of the franchisees who sought permission to sell their franchise were permitted to do so.

I think that these statistics speak eloquently to the absence of abuse that might warrant additional Government regulation of the franchise marketplace.

A franchisor generally invests considerable time, energy, and capital with the goal of establishing a reliable reputation for its product or service. That trade image is the most valuable asset for both the franchisor and the franchisee. Uniformity of product or service is what franchisors sell to the public. That is why it is so essential that a franchisor have the ability to police the system, not only for its own sake, but for the sake of the vast majority of franchisees who are in compliance with the system. If a member of the consuming public goes to a franchise in Canton, OH, and then sees the same signage in Ashtabula, they're going to expect that same standard of the product or service. If they are disappointed, it's going to hurt all of those franchisees, including the one who is in conformance with the system in Canton.

Where substandard performance is allowed to continue, it reduces the value of this trademark and diminishes the business potential and reputation of both the franchisor and its franchisees. Unless those franchisees are successful, the franchisor is not successful.

The primary method the franchisor has to protect its trademark is to terminate its relationship with a substandard franchisee in accordance with the terms of the franchise agreement, whose terms were disclosed, pursuant to Federal law, before that relationship was entered into. Additionally, under this presale disclosure required under the FTC rule, there is a statutorily required cooling-off period. That franchisee has to have what is normally referred to as a Uniform Franchise Offering Circular for 10 days before they're allowed to enter into that relationship.

That disclosure document includes, among other things, litigation history, bankruptcy history, and all litigation between the franchisor and franchisee. Pursuant to a recent revision of the UFOC, there also has to be a list of every franchisee who left the system during the previous year, for whatever reason—bankruptcy, death, termination. A franchisee is given an awful lot of information so he or she can make a wise business decision.

As logic dictates, so long as both parties considering a relationship are able to choose among alternatives, neither has the power

to dominate the other. If, after full disclosure, a franchisor tells a prospective franchisee to take it or leave it, I'm not going to change that provision in the contract, there's a very good chance that the prospect will leave it and look elsewhere. There is lots of competition. If you don't want the Wendy's, take a look at Burger King. If you don't like either of them, start your own restaurant.

Now, that might be a difficult decision. In the first 5 years, as we all know, 38 percent of individual startups fail. However, in franchising, the rate of discontinuation is less than 4 percent a year.

Although the decision to purchase a franchise may be a prudent one, no one is required to do so, and those that do make such a business decision should not be granted extra contractual protection from risk. The decision to be a franchisee is a decision to bear risk and be rewarded for it. Nonetheless, as the figures I mentioned earlier indicate, franchise terminations, nonrenewals and denials of transfer occur extremely infrequently. A franchisor with cause to terminate generally provides the franchisee with an opportunity to cure, not out of any sense of benevolence but out of self-interest. A franchisor who terminates or fails to renew an experienced franchisee would not only incur substantial costs, but cut off the flow of royalty income. Arbitrary and unfair terminations also impair the ability of the franchisor to build its franchise system. A franchisor has plenty of incentives to be fair if he wishes to retain his other franchisees and to attract new ones.

It is interesting to note that in its 1986 report on a proposed uniform franchise act, the American Bar Association Franchise Committee Task Force found that:

> There are strong business incentives for franchisors not to engage in arbitrary or abusive behavior, that they could incur substantial good-will losses if they exploit the discretion afforded to them in their agreements, reducing the value of future franchises.

I have already mentioned there is the Federal Trade Commission Trade Regulation Rule on Franchising and Business Opportunity Ventures which was promulgated in 1979. It requires extensive disclosure, somewhat similar to a prospectus for securities. It has a statutorily required cooling-off period. It lists litigation, franchisees that have left the system, and all the provisions in the contract with regard to termination. It explains what the rights and obligations of both parties are in those situations. If there is a covenant not to compete, which was mentioned by Ms. Taylor, that will be disclosed there too—before the relationship is entered into. By 1979, I might add, there were already 14 States which had on their books their own disclosure and/or registration regimes. Since the FTC got into the act, only one other State has enacted a new disclosure law, and that was California in 1981.

Additionally, there are some 17 States which one way or another regulate the franchise relationship. Although it is occasionally advocated by advocates of incumbent franchisee rights, only 2 of these State laws, those adopted in New Jersey and Wisconsin in the early 1970's, include a so-called "good cause standard" for franchise termination and nonrenewal. Rather than enacting restrictive legislation, States are now establishing programs to encourage franchising's growth within their borders.

In Maryland, IFA worked very closely with the legislature and State officials to develop the Nation's first program designed specifically to assist minority entrepreneurs interested in franchising. Other States, led by Michigan, have reconsidered in their entirety the franchise laws passed prior to enactment of the FTC rule.

Last, let me just mention the act adopted by an organization called the National Conference of Commissioners on Uniform State Laws. That body embarked on an effort in 1983 to undertake the drafting of a uniform act in the field of franchising. They recognized that the greatest problem facing franchisors today, and the greatest obstacle preventing franchisors from creating more small businesses in our country, is the diverse and often conflicting requirements under State law. This drafting effort was spearheaded by a law professor Jack Davies, a former president of the Minnesota Senate.

Successive drafts of the act, which runs some 47 pages were considered line-by-line at each of 10, 2- to 3-day drafting meetings by the Commissioners sitting in committee of the whole at the annual meetings of NCCUSL in 1985 and 1986. The act was adopted in the summer of 1987.

This committee studied intensively the relative merits of regulating the franchise relationship and worked strenuously to construct an act that balances the interests of franchisors and franchisees. The franchisor community that I represent isn't real happy about it, and I understand that the franchisee community is equally dissatisfied. Perhaps a case can be made for the argument that they hit a reasonable balance.

According to the comment following section 201 of the proposal, which is the heart of its regulation of the franchise relationship:

> The act relies on the duty of good faith and fair dealing rather than offering a code of prohibited or mandatory substantive actions or practices to govern the business relationship of parties to a franchise or business opportunity. More than 2 years of intense study and debate by the drafting committee, which considered several drafts that attempted to list prohibited and mandatory practices, led the NCCUSL to the conclusion that a list of prohibitions could not be expressed in a manner that was evenhanded, economically efficient, or responsive, to the interests of consumers and of other franchisees or business opportunity operators.

That is the end of my statement. I very much appreciate the opportunity to have testified before you today, and I would be happy to answer any questions.

[Mr. Simon's statement may be found in the appendix.]

Mr. PRICE. Thank you, Mr. Simon. Thanks to all of you for some very provocative and useful testimony.

I turn to the subcommittee chairman, Mr. Eckart.

Chairman ECKART. Proceed.

Mr. PRICE. Mr. Hiler.

Mr. HILER. Thank you. Mr. Simon, if I hadn't read Mr. Jensen's testimony, I would listen to you and say "Gosh, what's the problem here?" But obviously, Mr. Jensen seems to have a problem, having read his testimony and not hearing it directly.

I wonder, Mr. Jensen, if you might have any comments to Mr. Simon's testimony.

Mr. JENSEN. Off the top of my head, no, other than the fact that I think he's talking about franchisors and not franchisees. Appar-

ently that's where the statistics and information he is getting is coming from, that has been supplied by—whatever that organization was that is about to lose it's funding by the Office of Management and Budget.

Mr. SIMON. The U.S. Department of Commerce.

Mr. JENSEN. In many, many cases the nonrenewals and the things that you brought up there are handled in some manner by selling the unit, but in some way the franchisee is out of it. I question the statistics that you used. I believe those numbers probably come from the franchisor community as opposed to the franchisee community.

Mr. SIMON. I understand that Andrew Kostecka, the U.S. Department of Commerce employee responsible for putting together that survey, will be on the last panel. To the extent your question is about that data, you might want to address it to him.

If I may just respond a bit, Mr. Hiler, I don't mean to say there are not problems in some systems, in some companies, with some franchisees. What I attempted to say was that I do not believe there is a systemic problem in the franchisor/franchisee relationship. Certainly, there are isolated examples and there are unhappy franchisees out there. I would ask that this subcommittee be a bit cautious in generalizing from those examples.

Mr. HILER. In the statistics that you cited—and any of you could comment on this—is there more or less of a problem, or perceived problem, or is there any correlation between the perception of a problem and the fact of a problem? How many of the outlets, stores, or restaurants are owned by the company and what percentage is operated by franchisees?

Ms. Taylor, you seem to want to answer that.

Ms. TAYLOR. I'm not able to answer that specific question, but just responding to some of these statistics—and I don't know whether or not this is the case with the U.S. Department of Commerce. But one of the problems I frequently run across in the statistics is that franchisors will make statements like only 2 percent of our franchises fail. However, what you have is a case where maybe they sold the same franchise to three or four individuals who all failed, either went bankrupt or went under. But if the franchisor managed to keep the franchise open by reselling it, or by taking it over, that is not considered a failure.

I'm wondering, when they say a certain percentage of the franchises have been renewed, are they talking about locations or are they talking about people? There's a big distinction there.

The other problem that I don't believe the statistics address is the quality of renewal. For instance, I don't think there is any statistic about how many people are happy with the renewal, or how many people, if they could have walked away and had no covenant not to compete, would not have renewed.

Mr. SIMON. If I could address just two things. One, with regard to Ms. Taylor's last point on post-term covenants not to compete, they are out of favor with the courts. Many, many courts will not uphold them.

With regard to resale of franchises that may not be reflected in the failure rates by the Department of Commerce, this was a problem that was addressed by the North American Securities Adminis-

trators Association, which is responsible for creation of the Uniform Franchise Offering Circular format, known as the UFOC. Under recent revisions to item 20 of the UFOC, franchisors are going to have to list all franchisees that left the system during the previous year, for whatever reason.

As Ms. Taylor quite aptly points out, it is conceivable that you could have two or three franchisees—I don't know of a company that has this problem—that were all in the same unit. Nonetheless, effecti e January 1, 1989, if a prospective franchisee is concerned about this issue, they can just flip back to item 20 and they're going to have the names and last known addresses and phone numbers of those franchisees. The International Franchise Association distributes hundreds and thousands of books called "Investigate Before Investing." We tell prospective franchisees to ask all sorts of tough questions: Go talk to other franchisees in the system; they'll tell you what's really going on. The quality of that relationship is very hard to find in black and white print. But disclosure does allow prospective franchisees to get the answers.

Ms. TAYLOR. May I respond?

Mr. HILER. You can have the last word.

Ms. TAYLOR. I'm sorry, but there's a real problem. It's a good thing that right now all the present and current franchisees' names, addresses, and telephone numbers are listed in back of the offering circular. That's a good thing. It's a better thing that people who are no longer in the system, their identities, locations, and last known whereabouts are also listed.

But there's a real problem here, and that is, when a potential franchisee calls a current franchise and asks the question, "If you had to do it over again, would you do it," the franchisee knows that if he or she says no, and here's the problems that I've had, most often that potential buyer is going to go back to the franchisor and say, "Hey, I called some of your franchisees and this is what they told me." That franchisee, in the next couple of weeks, very often is going to find himself with audits, threats of nonrenewal, lessening of support, or too much support—someone in his store, overseeing everything he's going to do.

Franchisees are extremely cautious about saying anything against the franchisor because of fear. I think the subcommittee might have experienced some of that in trying to get franchisees in here to testify. So there is a problem. It's not as simple as picking up the telephone and asking current franchisees what the problems are.

Also, I would like to just throw in here that there is no private cause of action for a violation of the FTC rule, such as there is with the securities rule. There is also no requirement that a franchisor must disclose information which a prudent investor would like to know. Therefore, there's a lot of things that are not disclosed. There is no rule or no law that can possibly list every contingency that should be disclosed if it's there.

Mr. HILER. Thank you.

Mr. PRICE. I would like to continue to explore the kind of disclosure that is given and what these termination clauses actually contain.

Mr. Wild and Mr. Jensen, you both have had contracts terminated. What was the nature of the termination clause in your contract, and were you aware of the content of that clause?

Mr. Jensen, do you want to start?

Mr. JENSEN. The nature of our termination clause simply consisted of—one portion of it said scope of the work. In order to be renewed, was an impossibility. There were no alternatives. It was just build a new building under the current circumstances on the same location, where it existed, with no alternatives to move it to another location. It was physically impossible for us to conform to the requirements of the scope of the work that the company required.

Mr. PRICE. I'm talking about the initial contract and the conditions that were given under which it could be terminated.

Mr. JENSEN. Our contract was not terminated until the initial contract had run out. It just was not renewed.

Mr. PRICE. I see. Were there clauses——

Mr. JENSEN. We did not have contracts that were terminated while in the term of the contract. They just have not been renewed at the end of the contract.

Mr. PRICE [continuing]. So it was a nonrenewal.

Mr. JENSEN. A nonrenewal.

Mr. PRICE. Was there anything in the initial contract about the conditions of renewal or any kind of clause that would permit unilateral termination?

Mr. JENSEN. Gosh, we've had so many different contracts, I'm not positive about that particular individual contract, because that was signed over 20 years ago.

Mr. PRICE. Mr. Wild.

Mr. WILD. Our contract with this particular manufacturer had two methods of termination, that was stipulated directly in the contract itself. The first one was termination for cause, and that was to be on 30 days' notice by the manufacturer to the distributor. The enumerated causes were to be inability to meet quota, inability to pay the manufacturer the moneys that are due them in a prescribed period of time, and inability to adequately represent the manufacturer in the geographic area that was assigned to them by the manufacturer.

Then came the catch-all, where they said in the contract, this contract can be terminated by either party, without cause, on 90-day written notice. That was how we were terminated, for that reason.

Mr. PRICE. Was that contract drawn up in accord with some kind of State law, or State requirement?

Mr. WILD. I believe this particular manufacturer was incorporated in the State of Pennsylvania. In their contract they note that the laws of Pennsylvania will be the laws that will be enforced. I believe that's correct, isn't it, Mitchell?

Mr. KRAMER. Mr. Price, may I comment?

Mr. PRICE. Certainly.

MITCHELL KRAMER, ATTORNEY, FAIR FRANCHISING COALITION, PHILADELPHIA, PA

Mr. KRAMER. My name is Mitchell Kramer. I'm an attorney from Philadelphia and I represent the Fair Franchising Coalition, as well as four national trade associations composed of companies that are distributors and manufacturer representatives. I can give the subcommittee the names of those, but there's no point in wasting time on that now.

When it comes to manufacturers' representatives and distributors, everything that you've heard about franchise laws doesn't exist. There are no laws in the States that apply to representatives or distributors, other than the Wisconsin statute. That's the only State in the United States that deals at all with the issue of manufacturers' representatives and distributors. These companies constitute close to 5 million jobs in the United States.

The answer is that there is no disclosure requirement for manufacturers' representatives or distributors—even in Wisconsin. Wisconsin deals with fairness after the relationship has begun. The standard in the United States, as I see it—and I have not only represented associations and members of those associations who are representatives and distributors, but I have also litigated innumerable cases. I just got my ears pinned back in Tennessee this week, trying to save a distributor. There are no laws, there is no disclosure.

The typical contract that these companies enter into is either an oral contract, which the courts consistently have interpreted as being terminable at will, without cause. The Seventh Circuit Court of Appeals, in the last 2 months, in the *Borowski* v. *DePew* case, held that these oral contracts can be terminated without cause, for cause, or even for a bad cause, at will.

Where the manufacturers have seen fit to give the representatives or distributors a written contract, in virtually every case—not every case in the United States, because there are some cases where you have a little start-up company where the rep or distributor has some economic power—but where you get any sizable company dealing with a manufacturer's rep or distributor, the written contract invariably says, as Mr. Wild just said, it is terminable on 30, 60, or 90 days' notice, without cause.

The courts again consistently have said that since you have entered into such an agreement, issues of good faith or fair dealing are driven out. There is no such requirement since there is a contract. Even in the situation where there is an oral contract, the courts, by and large, recently—and it's increasingly going that way, actually—have tended to say that there is no requirement of fair dealing or good faith in the relationship. It says you're terminable and you're terminable.

What happened, as has been done with Mr. Wild, and is happening throughout the country with other representatives and distributors, literally companies are going out of business, employees are being fired—well, not fired; they've lost their jobs—because some manufacturer, as in Mr. Wild's case, in Britain took over the company.

I litigated a case last summer where a Japanese company bought an American manufacturer and terminated a guy who had just closed the biggest deal the company had ever made. On and on. I could go on, but I don't want to spend more of the subcommittee's time.

I thank you for allowing me to answer at least that half-a-question.

Mr. PRICE. Thank you. Let's turn to Mr. Simon. Could you elaborate on the questions that we have raised here? One question, obviously, is to what extent the generalization Mr. Kramer made about laws governing distributors apply to franchisors generally. Also, to what extent is the typical contract openended, in the way that Mr. Wild described? Is that, in fact, the norm, where termination is permitted for no cause, or do contracts typically contain particular circumstances or grounds for termination?

Are there State laws or regulations that require or put limits on the right to terminate? That, obviously, is also pertinent.

Mr. SIMON. I think we're dealing with apples and oranges here. I limited my remarks to business format franchising. When we're talking about manufacturers' representatives or dealership arrangements, you're basically talking about a wholesale/retail relationship. You're talking about a manufacturer or an oil refiner who sells hard goods to this dealer who resells them, and their profit is going to be based on the margin. That is very different from what goes on in business format franchising. Indeed, under Federal and State antitrust laws, with limited exception, franchisors cannot require that their franchisees buy products from them. A business format franchisor sells a business format, not goods for resale.

Mr. Kramer and Mr. Wild are quite right. The laws that regulate the sale of franchises and those State laws, with the exception of Wisconsin, which grant franchisees certain protections, are limited to business format franchisees and they do not grant dealers or manufacturers' representatives protections.

There are many other differences between these types of commercial relationships. Franchise agreements usually are almost always a fixed term. Fifteen or 20 years is the typical length of the agreement. Agreements with manufacturers' representatives and dealers, if there is a written contract at all, are often openended. Where a franchise termination is litigated, courts will ensure that there was a material reason based on the contract. It would not be a terminable-at-will situation like Mr. Wild has faced.

Mr. PRICE. In terms of State regulation, are there laws in a number of States that, in fact, limit the conditions of termination?

Mr. SIMON. Yes; there are some 17 States that in some way regulate the franchise relationship. In terms of the good cause standard alluded to earlier, only 2 States do that, Wisconsin and New Jersey, both passed early in the 1970's. Other laws do nothing more than make certain that the franchisee is given written notice of the termination, perhaps 60 or 90 days in advance, and that the cause of that termination is spelled out clearly. A typical franchise agreement already has provisions very similar to those, so that the incremental protection that franchisees might get from these laws is quite minor.

Mr. PRICE. Ms. Taylor.

Ms. TAYLOR. If I just may throw something in here, I have a tremendous amount of respect for the IFA and also for Mr. Simon. But I think it needs to be pointed out that recently the State legislature of Arizona attempted to pass a law whereby it would regulate renewals and nonrenewals of franchises and address this precise issue. The IFA was not shy about trying to stop passage of that legislation. Indeed, they were able to defeat it and then sent out a congratulatory memo to their members saying that they had successfully stopped that piece of litigation. I believe that's the case.

Mr. SIMON. Certainly true. Many of those members passed that along to their franchisees.

Ms. TAYLOR. So I just think that needs to be known.

Mr. KRAMER. If I may, the State laws, as I think Mr. Simon alluded to, basically deal with disclosure going into the relationship. They really do not deal with the ongoing relationship once the franchisee signs on. That's the problem. They do in the sense of the contract.

Now, as far as the rep and distributor goes, that's not so. There is no State law, really, other than Wisconsin. But what happens is, so long as the franchisor or the manufacturer—and there are overlaps in the problems, between what I will call the traditional franchisor/franchisee and the people that I tend more often to represent—so long as the manufacturer or the franchisor can terminate relatively easily, or set standards where a technical violation of those standards in the contract can lead to termination, so long as the franchisee, the rep, or the distributor has hanging over him the Damocles Sword of termination, the arrangement can be set largely by the one with the more economic power, the franchisor or the manufacturer.

For example, in the franchisee situation, you may have a wonderful contract that provides for how much the rep will make and all of the terms and conditions and the territory, but if he has 30 days' notice, all the manufacturer has to do is call him and say, "Let's change the deal, or else we're going to terminate you in 30 days." So the contract means nothing.

In answer to your question, Congressman Price, there is no State law that requires any disclosure going into a rep or distributor relationship. Even Wisconsin doesn't do that. Wisconsin deals with the relationship after it begins and says there shall be fairness and fair dealing. New Jersey to some extent, but it's a much lesser act. New Jersey does not deal with representatives and distributors. It deals with what I will call the traditional franchise relationship.

Mr. PRICE. Mr. Eckart.

Chairman ECKART. Is the question one of termination, talking about protecting people from termination? I'm not sure you ever could do it.

Ms. Taylor, might it not be an issue of being assured of the fair market value of their franchise upon termination?

Ms. TAYLOR. That is one of the issues. Certainly, if two people make a contract—and let's forget for the time being unequal bargaining power or any of the equity issues here—and the end of the term comes to pass and it is not renewed, or the renewal terms are offered in such a way that it does not make economic sense for the

franchisee to want to renew, he just can't do it, then you do have a problem of fair market value for the business.

It comes up in three ways. One, the franchisor may decide in that area that the business is extremely profitable and the franchisor wants to run it itself, and instead of getting 6 percent of the gross receipts, it will take all the profits.

The second way a franchisor is able to profit from this is that he fails to renew the franchise. At that time the business has a good reputation in the community, it's very valuable, and the franchisor turns around and sells it to someone else for a couple of hundred thousand dollars and therefore gets a great deal of money. In that case, my own personal belief is, based on experience, there needs to be legislation to compensate the franchisee for his investment and his risk, which the franchisor is now receiving a profit.

The third area where this becomes a problem is that covenant not to compete. It is true that courts disfavor it. In fact, there are some States that refuse to enforce them at all, California notably, Oklahoma another State. The fact of the matter is, over half the States of this country will enforce them. Many attorneys in this country are not familiar with the dynamics of the franchise relationship. There aren't many universities in this country that offer a course in franchising. It's a special kind of relationship.

In order to defeat a covenant not to compete sometimes you only need to know that you can only show there are no trade secrets involved. New York is such a State. But it's a very expensive thing to do, to defeat a covenant not to compete in States that do enforce them. So you have a problem where a guy loses his business, but it's more than that. He loses his investment in the business and he loses his skill. He loses the ability to apply his trade because he can't go down the street and open up another business under his own name. He can't do it. If he wants to stay in that business that he's been operating for 10 or 15 years, he has to move to a completely different community, in some cases a different State.

This problem, it's true, maybe should be addressed on the State level, since States do have laws and judicial common law that address covenants not to compete. However, franchising is a special relationship. It's not an employment relationship; it's not the sale of a business, which most States address. It's something that I believe Congress needs to look at very carefully within the context of the antitrust laws, because not only is the franchisor able to take over the business, he's able to get rid of the number one competition, the guy who can really compete.

Mr. KRAMER. Congressman Eckart, may I?

Chairman ECKART. Sure.

Mr. KRAMER. Thank you, sir. You asked about nonrenewal and termination. Certainly the Congress has dealt with that issue and has dealt fairly with it in the Petroleum Marketing Practices Act, where in that limited area Congress has passed legislation which protects the gasoline dealer from arbitrary termination, or termination without cause, so long as there's not a change in the marketing plan.

What we think Congress should consider—and obviously, I'm looking at it from the standpoint of the rep or distributor, but also from the standpoint of the franchisee, which I have represented

franchisees and I'm aware of the problems—is that perhaps the Petroleum Marketing Act should be extended beyond the limited gasoline area to all of the people who are similarly situated. Certainly the gasoline stations in this country have benefited by that act, and certainly the major refiners in this country have not been adversely affected if you look at their profits lately. So this type of protection, which gives stability to the little fellow, to the small business, we would request Congress to consider extending that type of protection to the rep, to the distributor, to the manufacturer, so there is a level playing field between the two. Thank you, sir.

Mr. PRICE. We have limited time, but I do want to follow up on this for just a moment, because a number of you mentioned the possible content of Federal legislation. Mr. Wild, you in particular talked about the need for Federal franchising legislation.

Could you be as specific as you possibly can about how this is similar and how it's different from the proposed uniform franchise act that is being drafted by the National Conference of Commissioners? What are the critical similarities and differences? I would welcome comments from any of you on that.

Mr. WILD. I think I would have to defer to Mr. Kramer, since he is more involved with the legislation than I am.

Mr. KRAMER. I have read it, Congressman Price. First of all, the Uniform Franchise and Business Opportunity Act isn't an act anywhere. It has not been enacted in any State, to my knowledge. It's simply a proposal by the National Commission.

Mr. PRICE. That's right. Of course, all of this is at the proposal stage.

Mr. KRAMER. Second, it basically deals with the same thing that the FTC Act does. First of all, it only deals with the traditional franchisee/franchisor relationship; it doesn't deal with representatives or distributors at all. Also, it basically deals with disclosure going in. It really doesn't deal with the ongoing relationship, except that section 201 has a general statement of a duty of good faith and does nothing more than simply say that exists. Based on recent decisions of the Federal courts, if there was a written contract, the duty of good faith would be subsumed in that contract and therefore section 201 of the Uniform Act would be meaningless. But basically, this Uniform Act deals primarily with disclosure going into the relationship.

Incidentally, it does not deal at all with the question of failure to renew or termination, improper termination. It does not deal with the sort of thing that the Petroleum Marketing Practices Act deals with very effectively.

Mr. PRICE. You're wanting to see specific restrictions on the right to terminate, and you see the Petroleum Marketing Act as a useful model in that regard?

Mr. KRAMER. I think it's an extremely useful model. The Petroleum Marketing Practices Act has not restricted the large refiners in the way they do business. They can still do business as they did before, so long as—they can't arbitrarily terminate the dealer, so long as it's not because he happened to be wearing a yellow tie and there's a new national sales manager coming in who doesn't like yellow ties, or who speaks with a foreign accent, because the company was just acquired by an overseas company.

So it seems to me that the Petroleum Marketing Practices Act, in the petroleum industry, has created a more level playing field between the refiners and the fellow on the street who markets gasoline. It seems to me that is ideally what we would propose that Congress consider, not something like this Uniform Franchise and Business Opportunities Act, which has been around for a while, which no State has seen fit to take seriously and pass, and which wouldn't be of any help if they did.

Mr. PRICE. The critical difference for you is that a Federal statute ought to somehow prohibit wrongful termination? Is it a critical difference?

Mr. KRAMER. Yes; termination or failure to renew, it's really arbitrary termination or failure to renew, the type of thing that Mr. Wild testified to, where they have told him there was no cause.

Mr. PRICE. You're also talking about shifting the burden of proof in instances of that sort?

Mr. KRAMER. That would be nice, but I'll take the proof the way I get it, if I had an act that would allow me to at least get to the courthouse door.

Mr. PRICE. Mr. Simon.

Mr. SIMON. Three quick points. It is true the NCCUSL Act has not been adopted by any State. It was only adopted formally by the Uniform Commissioners in the summer of 1987——

Mr. PRICE. Does it, in fact, reflect statutes that are in place in a number of States?

Mr. SIMON [continuing]. Contrary to Mr. Kramer's assertion, the duty of good faith and fair dealing does not inhere in all distribution relationships. The Uniform Commercial Code imposes a duty of good faith and fair dealing upon merchants. Many courts, however, do not consider business format franchising to be characterized by a relationship between merchants. The NCCUSL specifically provides that this duty applies to parties to a franchise relationship.

The third point about the proposed act is that, unlike the FTC rule, it grants a private right of action to franchisees or investors that did not receive proper disclosure.

Mr. PRICE. Thank you. We really are pressed for time. Chairman Eckart, unfortunately, had to go to another committee because of some pending business there. He may have some additional questions to submit, as may other subcommittee members, and we would hope that you would be willing to respond in writing if those questions do come to you.

In the meantime, we thank you for your testimony. It's very helpful. We will now call the next panel.

Mr. KRAMER. Thank you very much.

Mr. PRICE. Actually, we are going to combine the next panel, so let me call Mr. Byron Fox, who was originally scheduled for panel two, as well as Andrew Kostecka, from the Commerce Department; Professor Barry Kellman, Cleveland State University; and Ms. Kathryn Boe, from Creighton University in Omaha.

Mr. Kostecka, since your statistics figured so prominently in the last panel's discussion, I think we will start with you and then turn to Mr. Fox, Professor Kellman, and Ms. Boe.

TESTIMONY OF ANDREW KOSTECKA, FRANCHISING SPECIALIST, OFFICE OF SERVICE INDUSTRIES,INTERNATIONAL TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Mr. KOSTECKA. First, I would like to say that I am not a lawyer. I have been working for the Commerce Department for the last 22 years. I initiated the Franchise Program. The Franchise Department of the Department of Commerce consists of one individual, myself.

For 17 years, I have conducted the only survey on franchising, public or private, and the results have been published annually in the report, "Franchising in the Economy."

In addition to that, for 21 editions, I also produced another book called "The Franchise Opportunities Handbook," in which the current edition lists the franchise offerings of 1,455 franchisors, providing much valuable data for prospective entrepreneurs who want to enter the field of franchising.

We have articles like Investing in the Franchise, Checklist for Evaluating a Franchise, data on Government and nongovernment sources.

This book, incidentally, in the last 10 years has been one of the 10 best sellers in the Government Printing Office. In addition to that, I conduct trade missions annually for franchisors. I help franchisors expand to foreign markets.

I have conducted and led about 25 trade missions, helped franchisors sign over 100 franchise agreements in various parts of the world. In addition to that, I make many presentations throughout the world, speaking to franchisees, franchisors, educators, and the general public on the subject of franchising.

Mr. PRICE. Fine, your full statement, I should have made clear earlier, will be submitted for the record. We now have a vote being called, so if you could summarize your testimony, perhaps in the next 5 to 6 minutes, we will return after the vote and continue with the rest of the panel.

Mr. KOSTECKA. All right. I just want to talk about the system of franchising. As a result of my survey, franchising is a very important part of the U.S. economy. By the end of this year, including all types of business services and franchising, we are talking about sales that will generate about $640 billion, providing employment for 7.3 million persons through 509,000 units.

In my opinion. over the last 22 years, especially since 1979, I have seen a big change in the franchise system with the addition of the Federal Trade Commission disclosure requirements. I think it has helped the industry tremendously and it has been very successful.

There are abuses, naturally, but I have seen, according to my survey reports, the abuses have been very small. As a result of the survey that I have conducted for the last 17 years, the violations, terminations, and renewals have been very minimal and the vast majority have been by franchisees, rather than franchisors.

Mr. PRICE. By very minimal, can you put a number on that?

Mr. KOSTECKA. I have the numbers, but I don't have the percentages. I think Neil Simon mentioned the percentages. I didn't realize at that time it was required.

But, for example, they are all in the report, "Franchising in the Economy." For example, for the year 1986, which was the last actual year that we have done a survey, of the 12,999 contracts that came up for renewal, 12,073 were renewed. Now, roughly from what I have heard, about 92 percent were renewed.

Mr. PRICE. Could you just indicate—we can, of course, get into this more during the question period—what your sampling procedure is, on what basis was that sample drawn?

Mr. KOSTECKA. This is not a sampling procedure. I have received returns from 2,177 business format franchisors, so this is not a sample return. I have covered about 99 percent of all business format franchisors in operation at that time. I conducted this survey in 1987, the summer of 1987.

So it is not a sample survey; it is an actual survey of all known franchisors.

Of the nonrenewals, the vast majority were by franchisees or by mutual consent.

Now, in the terminations, of the various terminations that occurred in 1986, there were 7,361 termination of franchise agreements in 1986, of which 3,075 were terminated by franchisors, mostly for nonpayment of royalties or other financial obligations, 3,914 were terminated by franchisees, while an additional 372 were terminated by mutual agreement.

Now, as far as franchisees that asked permission from the franchisor to sell their franchises to other business persons, of 4,202 franchisees that asked for permission to sell their franchise in 1986, all but 94 were approved to be sold to other individuals.

So, according to these statistics, personally, I don't really see any problems—any need for additional legislation, on terminations or renewals, but I am speaking from a nonlegal viewpoint.

Mr. PRICE. I am afraid we are going to need to break for the floor vote.

We will convene after we return.

[Recess.]

Mr. PRICE. Mr. Kostecka, unless you have something critical to add, I think we will move on to the next witness——

Mr. KOSTECKA. No; I have nothing critical to add.

Mr. PRICE [continuing]. Then draw out further information from you and the others in the period of questioning.

[Mr. Kosteka's statement may be found in the appendix.]

Mr. PRICE. Mr. Fox, please.

TESTIMONY OF BYRON FOX, ESQ., KAUFMANN & CAFEY, NEW YORK, NY

Mr. Fox. Thank you, sir. My name is Byron Fox and I have practiced law for about 30 years. My fields of specialization or concentration—because we are not allowed to specialize in New York—are franchising and distribution, antitrust and securities regulation.

Without going into any long list of qualifications, it is pertinent for me to say that I have taught franchising at Fordham Law School in New York and at the University of Virginia Law School and I have written a lot about it, and perhaps most importantly for

today, I have been a member of the drafting team that put together the Uniform Franchise Law that is just about to be promulgated by the National Conference of Commissioners on Uniform State Laws.

I have to begin there by making a small correction which I have already told Mr. Kramer about. He had made a comment to the effect that no State has chosen to take that act seriously. Well, in point of fact, through the procedures of the National Conference, the act has not officially been promulgated and won't be until next week. So, indeed, no State has taken it seriously or not seriously; no State has had the right to consider it.

I also have to add, in the interest of full disclosure, that I am a member of the Legal Legislative Committee of the International Franchise Association, although I disclaim that I am here carrying their brief or anybody else's.

I begin with the notion that franchising works. I am not sure whether it was Casey Stengel or Yogi Berra who said, "If it ain't broke, you don't have to fix it." You have heard a lot this morning about statistics and the fact that the franchising over the past three decades of its modern-day existence has grown to a point where it very nearly accounts for 40 cents out of every retail sale dollar in America. To me, that is an astonishing statistic.

It didn't happen because franchisors oppressed franchisees. It didn't happen because franchisors terminated them without cause or in order somehow to grab a territory that the franchisee had developed. It is simply not true.

It is also important, I think, in the spirit of understanding to look at what franchisors really are, and that is particularly pertinent in a hearing before a committee dealing with small business. Most franchisors are small business people. It is almost universally misunderstood that they are small businessmen and women, and for every McDonald's chain, there are simply thousands of small businesses who seek to expand by having their franchisees copy what they have developed through their own energy and foresight and investment.

In terms of the present regulatory pattern, I can see some room for improvement, and that was one of the purposes of having the efforts of the National Conference directed to franchising. I assure you, we did spend 10 3-day weekends in a hotel room in Chicago, which was much, much too steamy hot in the summer and too darned cold in the winter, but we still spent those 3-day weekends drafting and redrafting and listening to people from every kind of franchise business, franchisors, franchisees, distributors, distributees, manufacturers, direct sellers, and from all this, came away with a Uniform Franchise and Business Opportunities Act which will be offered to the several States very shortly.

We dealt particularly with the question of whether to have termination nonrenewal legislation and we struggled—Lord, did we struggle with that issue, and did we do battle and there were many, many, heated moments. We came to the conclusion that that particular kind of legislation would do very little good, but that a good-faith standard more clearly defined, perhaps, than in the Uniform Commercial Code, would probably offer adequate judicial

guidance to provide fairness under a great variety of circumstances.

That was not a reckless or rash decision, nor is it one that binds anybody, but it certainly was one that was the product of an enormous amount of thought.

I would like to offer, sir, for the record, if you think it appropriate, a copy of the Uniform Act so that it would be an official part of these proceedings. Otherwise, I am simply very happy to turn it over to your staff.

Mr. PRICE. We will gladly add that to the record at this point.

Mr. FOX. OK, I will take care of that detail, sir.

[This information may be found in the appendix.]

Mr. FOX. The regulatory pattern of franchising, as you know, is a dual or two-tiered one. There is the FTC Act and then there are 14 State registration and disclosure laws.

As a franchise law practitioner and teacher, I can tell you that the registration and disclosure process, as it presently stands, is a terrible mess.

With respect to any given franchisor client, we are required to run for a national program 18 separate registration documents, 18. That costs small business one heck of a lot of money.

We would like—we, I should say I because there is no we—I would like to suggest straight out that the subcommittee give very, very serious consideration to the Uniform Act and ask itself whether or not that act should become the national standard for franchise disclosure registration and the extent you want to deem it such the governing star for the franchise relationship.

It is not as far-fetched a suggestion as you might think, for I believe that statute is the product of a great deal of thought and, as Mr. Simon pointed out, has all of the substance that makes everybody slightly unhappy, and as a sometime litigator, I know that is usually the best result. But I certainly hope you will consider that seriously.

In the remaining minute I have, I would like to make a brief comment about termination and nonrenewal as an issue. I find that much of the thinking in this area is confounded by very curious distortions of existing law. Concepts are thrown about, such as good cause—I am not quite sure I know what that means—fiduciary duties, conscionability or unconscionabilities and words of that ilk, but never do the proponents of these concepts tell us in any analytical way precisely what these terms mean and how they justify tough legislation against terminations and nonrenewals.

I think their argument boils down to the fact, the misperception that all franchisors are large and evil and all franchisees are small and helpless. That is utter nonsense.

Let me conclude by saying that small businesses usually fail and they fail in substantial numbers. Franchisees, even if their franchises are occasionally resold, just don't fail. The numbers are tiny, and they succeed largely because of the spade work that was done for them. They invest in a proven system. They purchase a license under a trademark and a method of business developed by somebody else at enormous expense to that somebody else.

Every one of these franchisees, when he or she was a prospect, did not have to buy in. They could have walked away. What is

clear to me is that once in, you don't get a perpetual free ride. Thank you, sir.

[The statement of Mr. Fox follows:]

Mr. PRICE. Thank you.

Professor Kellman.

TESTIMONY OF BARRY KELLMAN, CLEVELAND STATE UNIVERSITY, CLEVELAND MARSHALL COLLEGE OF LAW, CLEVELAND, OH

Mr. KELLMAN. Thank you. My name is Barry Kellman. I am a professor of law at Cleveland State University.

I would like to commend the subcommittee for holding this hearing on an important matter of economic policy which, to my way of thinking, traces back to hearings held 20 years ago by Senator Phillip Hart and hearings held a decade ago by Congressman Abner Mikva.

I see the subcommittee's hearing today as part of a decades-old process to try to deal with some of the problems generated by franchising.

Congressman, with nearly two-thirds of $1 trillion in annual sales and representing 30 percent of the Gross National Product, franchising hardly needs this law professor to extol its importance in the American economy. Franchising has grown because franchising is a successful way of distributing many products and services. Like the corporate form of doing business, which burst upon the American scene in much the same fashion nearly a century ago, franchising has succeeded because it offers very real economic incentives. However, like the early evolution of the corporate form, franchising has caused a number of serious problems which I believe lawmakers must address.

In my testimony, I will repeatedly draw analogies from franchising law to corporate law. I believe that many of the problems generated by franchising are, in fact, analogues of problems faced by those who invest in corporate securities. Indeed, the reform that I call for at the conclusion of my testimony—that is, the grant of appraisal remedies to terminated franchisees on the basis of going-concern value as a continuing franchise, derives exactly from the slowly evolving doctrine of corporate law, which holds that shareholders forced to surrender possession of their stock are entitled to similar appraisal right.

Mr. PRICE. Could I suggest, Professor Kellman, that we put your entire statement in the record and that you summarize as briefly as you can so we can move on to the questions? We will put the entire statement in the record.

Mr. KELLMAN. All right; most franchising problems can be put into two categories: Those problems which arise prior to the entering into the relationship, problems involved in the solicitation of a franchise relationship and the second category being the problems involving the ongoing relationship, primarily termination and nonrenewal.

As to the first set of problems, 15 States have enacted disclosure laws, plus, as we have heard numerous times this morning, there is the FTC rule requiring disclosure.

I would like to first of all second Mr. Fox's statement that there is a real need for uniformity in disclosure regulations. Then I would like to go on from that position and suggest that while disclosure remedies have had a long history in successfully preventing deceptive acts and practices in the sale of franchisees, such deception is not the only problem of franchising.

Necessarily, disclosure regulation can do little to control the ongoing relationship, and most important, the ending of the franchise relationship. It is to those set of problems that I would like now to turn.

I strongly believe that the starting point of any analysis of problems throughout the franchise relationship must begin with the gross power disparity between the parties. Advantages in bargaining power, financial strength and access to information lead to one-sided franchising agreements which can be presented on a take-or-leave-it basis.

During the relationship, each franchise faces the threat of termination and the possible loss of his capital investment. In jeopardy is his chance to earn a living as a franchisee and even thereafter if he is subject to a post-term, noncompetition covenant. The termination of a franchise is likely to have dire consequences if the franchisee has an exclusive dealership and sells only one product; then the termination, in effect, puts him out of business.

In any event, the termination can always be said to inflict hardship on the franchisee. How often do we see litigation involving a franchisee terminating a franchisor?

Furthermore, the franchisor's power to terminate can be translated into the power to coerce behavior under threat of termination. The franchisor and the franchisee each are aware of the consequences of termination and that knowledge is power in itself.

Thus, whatever advantage the franchisor's superior bargaining power established at the outset of the relationship, as performance continues, that advantage shifts ever further toward the franchisor because the more time, effort, and capital the franchisee spends promoting the product, the more reticent he becomes to lose the advantage of the relationship and the more power the franchisor has over him.

Closely related is the problem of nonrenewal. Ultimately, all franchises come up for renewal. The equity built in the business by the franchise is at that point in jeopardy. As the franchisor may be totally free to deny renewal at any time during the relationship, the franchisee may die, become disabled, or decide to sell or give away his franchise. Restrictions requiring that the transfer be approved by the franchisor are often used to obtain valuable assets for a depressed price, leaving the franchisee or often his family with little to show for a lifetime of effort.

At this point, I would like to address a few comments to much of the testimony made earlier this morning regarding the statistics of wrongful termination or wrongful nonrenewal.

I am willing to believe the numbers presented. However, I have a different interpretation of those numbers.

First, those numbers fail to reflect the number of instances in which the power of termination is used to coerce behavior. Statistics only reveal the number of actual terminations.

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Furthermore, I think, as a legislative body, we should not say that because most of time the system works; therefore, we should ignore those instances when the system does not work. The fact that there are many instances in which franchisees put great labor and capital and effort into building a franchise and lose the value of that franchise is to me sufficient reason to consider solutions to the problem.

However, the other side should be recognized as well. There may be good reasons for a franchisor to terminate a franchisee or to restrict its transfer. The franchisee may have failed to transact business sufficiently well to meet competition. Perhaps the franchisee failed to meet a sales quota.

If the franchisee fails to promote the product adequately, refuses to provide necessary services to customers or is lax in pushing for new sales, the franchisor should be able to terminate without fear of legal liability.

The task of any serious effort at reform must be to maintain the right of franchisors to manage their franchise network in their best competitive judgment, including affording them the right to determine who shall be their franchisees with the right—and that must be balanced with the right of every franchisee to receive the full rewards of his efforts.

However, existing law is not at all directed toward that goal. Fifteen States have laws—excuse me, most States have laws affecting termination cancellation and nonrenewal of franchisees. These State statutes differ on significant details, but they all share in common a vague substantive standard, sometimes referred to as good cause, good faith, just provocation, not unfair. These slippery terms are rarely defined.

But what is clear is that these State statutes have generated an awesome and bewildering array of litigation, leaving the judiciary with the thankless task of determining on a case-by-case basis whether the termination is legally permissible.

On the Federal level, the good-faith standard is also found in the Automobile Dealer's Franchise Act, which permits an automobile dealer to sue for damages sustained by reason of the manufacturer's failure to act in good faith. This good-faith standard has been narrowly constructed to prohibit only coercion or intimidation; that is, a wrongful demand backed by sanctions. A simple refusal to deal, even if arbitrary, is not actionable.

The Petroleum Marketing Practices Act is a step in the right direction. It sets forth in far more detail under what circumstances a franchisee may be terminated. However, the reasons allowed for termination are sufficiently broad to encompass most of the party's relationship.

Finally, and by far most important, is that body of law known as the Federal antitrust laws. With its focus on the promotion of competitive conditions, antitrust law is mismatched to the task of providing fairness for persons involved in the franchising relationship. An overwhelming quantity of antitrust litigation brought by terminated dealers shows conclusively that the termination of a dealer is, in and of itself, legal.

A producer can incur antitrust liability only if the termination was casually connected to an act or restriction which itself is anti-

competitive. Dealer terminations are culpable acts only if the termination was a manifestation of an otherwise anticompetitive scheme. Thus, terminations for failure to comply with an illegal tying arrangement, exclusive dealing arrangement or reselling restriction may give rise to antitrust concern if the producer has market power and if the restriction is the result of coercive use of that power.

I would like to suggest that in terms of resolving the problems faced by most terminated franchisees, the antitrust laws are, in fact, irrelevant.

What is needed is a system which recognizes the unique nature of the problem and approaches it from a consistent theoretical framework while applying it to a logical remedy. Every franchise agreement contains elaborate provisions governing the matters of transfer and termination. The good-cause legislation fundamentally represents that franchise cancellation is a matter of contract law, permissible when in conformity with the terms of the agreement, impermissible when motivated by bad faith.

From this beginning, the rules of the game have been developed. Failure to prove to a judge's satisfaction that the facts surrounding a specific cancellation merit its placement in the for-cause category results in a legal penalty being applied.

I would like to suggest here that more is at stake than the standard sales agency relationship. The parties' relationship extends beyond the contract and more is mutually expected than the best-efforts duty of sales law.

The franchisor demands that the quality standards he has maintained will be held out to the public. The franchisee needs the national expertise and training and advertising along with the uniform product.

Each party has an investment in the enterprise and mutually depends upon this blend of independent local service with the uniform national character of the product for its success. The proper approach must have as its goal the ultimate allowance of the dissolution of the relationship when the parties want it.

From the outset, the relationship is founded upon mutual trust and the desire to work together toward a common goal, namely, a net profit. The decision to terminate means that for whatever reason, at least one of the parties no longer has that desire.

Any approach which ignores this crucial fact overlooks the very essence of the franchising relationship. It would be better to allow cancellation in all cases. The parties should be free to come and go for whatever they feel are just reasons.

However, the termination process itself should be legally monitored. The franchisee should be compensated for the business which he has lost. In other words, if the effect of a disparity of bargaining power confirms unreasonable gains upon termination, then the law should provide that those gains be equitably divided. Thus, upon cancellation, the franchisee should receive exactly what he would have received from a voluntary sale, the fair-market value of the business.

In a franchise situation, if every termination required a payment to the franchisee in an amount equal to the fair-market value of the business, each decision would be assessed independently, as it

should, from a strictly business frame of reference. If it is more profitable to keep the outlet in operation than to buy it out, then no termination.

By choosing the fair-market value of the business as a remedy, franchise terminations would be removed from the judicial arena and returned to the business sector. Indeed, once an appraisal is completed, the court's role would be over. The relationship would be ended and each party would receive its fair share.

In conclusion, I would like to note that there is nothing new in this idea. Senator Phillip Hart proposed 20 years ago the Franchise Competitive Practices Act, which provided that if a franchisor terminated a franchisee, the franchisor would be liable to pay the franchisee the market value of the franchise, including good will.

As in regard to many policy matters, Senator Hart was well ahead of his time. I would suggest that the next Congress reconsider this proposal. Thank you very much.

[Mr. Kellman's prepared statement may be found in the appendix.]

Mr. PRICE. Thank you.

We will break briefly, as briefly as possible, and come back and hear Ms. Boe's testimony and then have our questions.

[Recess.]

Mr. PRICE. Mr. Brown, why don't you join us at the table here and we'll just integrate your testimony into this panel.

We will next hear from Ms. Boe and then take Mr. Brown's testimony to round out this panel's presentation. Ms. Boe, please.

TESTIMONY OF KATHRYN L. BOE, ASSISTANT TO THE PRESIDENT AND ASSISTANT DEAN, SCHOOL OF LAW, CREIGHTON UNIVERSITY, OMAHA, NB

Ms. BOE. Congressman, it's an honor to be here.

I am assistant dean at Creighton University School of Law, where I have taught franchising for 6 years. In addition to that, for about the last decade, I have represented various franchisees and franchisors in their problems, and I am one of the authors of "The Franchise Option" and one of the editors of the ABA's Franchise Law Journal.

You asked me to address six questions very briefly, and I would like to touch on each of them succinctly, and then we can get on to our questions.

First, you asked that we discuss the stages of a franchise relationship and the problems that are encountered in each one of those stages. I would like to precede my response by saying franchising is not a panacea for profitability. Franchising is just one of a number of forms of business expansion for a business idea. It is no more a guarantee of success than is incorporation. And there are problems with each one of the stages of a franchise relationship for both sides.

The first stage of a franchise relationship we might call the evaluation stage. This is the stage of introductions, where each party is seeking to learn more about the other. For the prospective franchisee, FTC Rule 436 is an immense help because it requires that a

good deal of data be provided in a specific format. That same approach is used by a number of State laws.

What are the problems with this approach? For the franchisor, the problem is that the proliferation of State laws may require a number of different disclosure formats, which means that the franchisor can easily have to spend a good amount of money in preparing a number of different disclosure documents, and the end result does not necessarily provide any better protection for the prospective franchisee than if he had had only one document to start with.

The second difficulty with this stage is a problem for the prospective franchisee rather than franchisor, and that is that although the data is very helpful, there isn't enough of it. What the franchisee really needs may or may not be provided or be providable by the franchisor. The first kind of data he needs is solid information as to how good a market niche there is in the territory he's considering for the product or business he's considering. You can understand why the franchisor would be very reluctant to provide that data. The experience of other franchisees might not be entirely comparable, or if the franchisor is too positive about the whole possibility, he might find himself down the road being accused of misrepresentation or fraud.

But many prospective franchisees haven't the vaguest notion how to evaluate a market niche. The most that many of them will do is to scout around existing franchise outlets to do a sort of customer count.

The second kind of data that isn't provided, and perhaps can't be provided, is a hard analysis as to the individual franchisee's abilities and goals, and his family's involvement or commitment to the project. Some franchisors spend a good amount of time in the evaluation and application process trying to identify this, because the deal won't work for the franchisor if it doesn't work for the franchisee.

The third kind of data desired is the kind you could have anticipated yourselves, without having held these hearings. That is, how much can I potentially make out of this deal. With any kind of investment, that's what you would want to ask.

It's ironic that this is the simplest question to ask but—if one is to comply with our laws—the most difficult to answer. The Federal rule says you can answer this question if you provide the data in the Earnings Claims Document. What most franchisors have done is to decide instead to make no earnings claim.

But, the FTC did a study themselves 4 years ago to find out what really happened when prospective franchisees sought such information. It was amazing. Many got their earnings claims, although for most of them those earnings claims came under the table, so to speak, in what we might call the cocktail napkin conversation, where the franchise salesman says "Now, I will deny ever having said this, but I can understand where you might want to know how much you could make before you put a second mortgage on your house, and so forth, so I'll tell you that you can figure roughly that you'll be able to buy a Buick next year, or people in your situation may earn as much as * * *" and then he fills in the blank.

It isn't that he's doing anything necessarily outlandish because it's a logical question. This particular issue needs to be dealt with and has been addressed recently in the UFOC, where the format is being made easier in this regard.

The first stage, then, relates to gathering data. The second stage, once contracts are signed and money paid, the second stage we'll call the start-up franchisee. Now, at this point the franchisee sticks all those magic papers in a drawer and forgets them, assuming he ever read them in the first place. During the start-up phase, the most important problem for both the franchisee and franchisor is training. Training will be the determinant of whether the franchisee makes money. Yet we have to face the fact that for the franchisor this is also the most expensive part of the deal. If he designs good materials and carries out a good training program that carries right through into the start-up phases with a grand opening, he may well spend far more than the initial franchise fee in getting the franchisee going.

The third stage of the franchise is the established franchisee. By this time let's say that the franchisee has been through a cycle or two, at least one annual business cycle. After he's been through perhaps two or three, he knows the system pretty well. At this point the question for the franchisee becomes, "What has the franchisor done for me lately?" The question for the franchisor then becomes, "What can I do to establish and maintain ongoing value in my system?" Now—as later—communication is essential because each can learn from the other and both can profit together.

The final stage we might call the end of the affair, or termination, expiration, or renewal. As we have listened to the testimony this morning, I have often wondered why it came as such a surprise that the relationship was ending. A franchise is not a permanent relationship. It is not designed as any kind of business marriage. The fact that a franchise is for a term is spelled out in the contract and very explicitly in a number of the items in a disclosure document. The conditions under which the franchise may be renewed or terminated, the costs associated with those particular activities, they're all laid out very clearly ahead of time.

However, when the event finally approaches, it doesn't mean that there aren't problems for both sides. Ideally, at the end of the term of a franchise, both parties ought to be able to shake hands and wish each other well and go their own way. In the case, however, of a termination, that's very seldom true. A termination involves issues and problems of cause, notice, and possible repurchase of inventory. The noncompete agreement is and is not a big issue, first because some States won't recognize such agreements at all, and second, because if they're going to be recognized, even as spelled out in the initial agreement, such agreements must be reasonable in time and geographic scope.

The role of the FTC in franchising was your second question, and I think I have already addressed that. That role has been primarily to require the disclosure of data before the sale. I think it does that very well and it's enforcement actions seem to be much more aggressive and assertive in recent years than they were in the past.

The third question you asked was does the Federal disclosure rule provide sufficient data to help an informed business decision. Except for the addition of more information on earnings, I would say that essentially that's true.

The fourth question you asked was what's the impact of the myriad of State regulation on franchisors. Would a uniform franchise law be beneficial. The myriad of State regulations has the effect of almost forcing certain bizarre decisions on franchisors regarding their geographic pattern of expansion. I'm working right now with a franchisor in New Jersey who is trying to avoid New York at all costs, which is ridiculous given what the business ought to do. But because of the difficulty in registering in New York, other States will be chosen first.

Would a uniform State law be beneficial? I'm afraid a uniform law will ultimately have the effect of multiplying the number and complexity of State statutes already there and they will not end up being uniform. The uniform law will be used as the starting place for State legislators, who will then adapt the statute to accommodate what they perceive as local problems, or to handle particular constituencies.

The fifth question you asked——

Mr. PRICE. Could I interrupt you at that point?

Ms. BOE. Yes.

Mr. PRICE. Should one conclude then, from what you just said, that you think some kind of Federal preemption is desirable?

Ms. BOE. Absolutely, Congressman. In my ideal world, what we would have is a preemptive Federal law requiring presale disclosure and the filing of the document in Washington with the Department of Commerce to facilitate more comprehensive data gathering. This really ties into the next question that you asked, which was what is the role that you think the Department of Commerce ought to play.

Right now, the statistics that are gathered by the Department of Commerce are used by all of us, by the franchisors, the franchisees, and the academics who study the whole phenomenon. They are amazingly comprehensive. There are some problems with them, but the fact that there are some problems certainly doesn't mean we should eliminate the whole process.

Yesterday I decided to do a little first hand research and I went over to the Government Printing Office store on 15th Street. I walked in and said I was studying franchising, "What do you have to inform me about this?" They brought out the two publications, Franchising and the Economy, and the Franchise Opportunities Handbook, which by the way was $16. I thought we have to be making money off that one.

I said, "Well, there aren't very many of these left on the shelf. Do you sell very many?" And the woman looked at me, Ms. Johnson, and she said, "They are always among our top 10 sellers. If they aren't in the top 10 this month and last month, they're right up at 11 or 12." I said, "Did you know they're considering stopping these publications?" And her eyes got big and she said, "Why?"

You asked the question is there a problem with particular parts of the data. I will tell you that yes, I have asked the same question about terminations and nonrenewal data that were raised earlier

today. For instance, if a franchisee is in trouble and the franchisor buys him out, the franchisee might have considered it a business failure, whereas the franchisor will mark it down as a resale. So I suppose that we could define more precisely how we categorize some of these situations. But this certainly isn't a reason to totally eliminate the whole project.

Could a private agency do this as well? No; I think the extraordinarily high rate of response to the Department of Commerce questionnaire can't be duplicated by any academic survey that I've ever known in the franchise area, or by any IFA survey.

What future trends or legislative regulations do we see. Unless we have some Federal preemption in franchising, which is almost inherently expansive and multi-State, we're going to have a multiplication of the State statutes that are already on the books. This adds virtually nothing to the protection of franchisees. It just increases the legal costs involved for the franchisor.

The second trend that I see is a dramatic increase in international expansion for American franchisors. We already see that occurring now, which has a wonderful effect on our economy, because it means that royalties, hard cash, are coming back into this country in return for this sharing of our business ingenuity.

I would like to leave with one thought. Franchising is just one option in business expansion, but it has been a phenomenally successful option for many people, the big people and the little people. It's as good an example as I know in business expansion methods of the fact that the deal won't work unless it's good for both sides.

[Ms. Boe's prepared statement may be found in the appendix.]

Mr. PRICE. Thank you. Mr. Brown.

TESTIMONY OF HAROLD BROWN, ESQ., LAW OFFICES OF HAROLD BROWN, BOSTON, MA

Mr. BROWN. On the way down here—and it took me three planes to make the trip—I was reading an article in the National Law Journal dated Monday, August 1, 1988. I would like to share one sentence of it with you. It's about Dean Roscoe Pound at the Harvard Law School:

> He taught that the law must continue to develop new concepts that take account of actual social conditions and permit people to exercise a measure of control over them.

I know of no more magnificent statement to characterize what I think this hearing is all about. I would like to commend it to you. I think the work you do here is in the finest legal tradition.

Rather than reviewing what my good friend, Kathryn Boe, has been telling you, I would like to concentrate on some of the hot spots, because I think that may be where you would prefer that I go.

Mr. PRICE. We will put your entire statement in the record and would appreciate your summarizing it for us.

Mr. BROWN. Thank you. The regulations that currently exist need help. One of the greatest places in which that help can occur is in a better understanding of what are franchises and what franchises should be regulated. Currently, most State regulations—indeed, the Federal Trade Commission Rule—focus upon the pay-

ment of some minimum amount of money within a designated period, such as $500 within 6 months or some such. That's an historical anomaly that derived from the early activity of the State of California, which before all of these regulations sought to characterize a franchise as an investment contract and, therefore, subject to the blue-sky laws.

The same excuse was used to fend off objections by major, old-time franchisors, like the automobile manufacturers, gasoline service station dealers and many others, who were objecting to being regulated, and since they didn't sell their franchise—that is, charge a price for the license—this type of a distinction allowed them to obtain exemption, or at least seemed to allow them to obtain exemption. The third thing was the thought that possibly more of the abuse occurred in the fields where franchises were sold.

But the impact of this omission is very severe. In point of fact, every franchise that's worth its salt involves the investment of great sums of money, often borrowed, but nevertheless, large sums. Whether it is a fast food franchise, where the building now costs $700,000 to $1 million to build, plus the inventory, plus the losses during the break-even period, or an automobile dealership, a hotel, or otherwise, seven figures are not at all unusual.

Franchisors get great benefit from this very large investment by their franchisees, and those franchisees go through the same trauma, the same problems, the same long-term difficulties, that all franchisees go through. They should, indeed, be included.

Perhaps one of the most obvious of them are the so-called independent insurance agents who do business under the name of their franchisor insurance company and uniformly do business under a contract that expressly gives the franchisor the right to terminate at any time on 30 days' notice, with or without cause. Now, a general agent may have 250 or 300 subagents, all independent sublicensees, all of whom are subject to that same traumatic impact.

Now, what happens when this type of power exists; that is, the constant threat of termination or, as Dean Kathryn Boe has indicated to you for the finite franchise, the constant problem of "Do I get my renewal?"

Have in mind that franchising is a method of raising money in which the franchisor does not issue stock in the franchisor company; he does not sign a promissory note to repay the funds; he licenses the use of a business format and ultimately seeks to recapture the good will that is thereby developed. In a societal sense, I believe that both the Federal Trade Commission, and certainly many States across the Nation, have recognized that this is an anomaly and a new situation in which these people, all of them, are entitled to some form of protection for their investment of time, money, and energy.

They're not entitled to absolute guarantees. I was once asked by a commission in Texas what do I want for a franchisee. I think that's the focal issue. The answer is, a reasonable opportunity to succeed, plus reasonable protection for their investment.

That means that franchisees should not be subject to the constant imposition of requirements by the field supervisors or, indeed, by the franchisor headquarters, that are unreasonable, ar-

bitrary, or whimsical. The theory that franchising has now grown up and doesn't need these controls is wrong.

Congressman, I wish that you would ask me about some people in your State. I wish you would ask me for the names. I have not provided them, but as I go through, just ask me and I will give you names, addresses, and dates. There is no other way to understand fully the substance of what I'm trying to tell you.

Under the aegis of these controls, a particular franchisor in your State requires that all its fast food franchisees buy the raw hamburger from one of its wholly owned subsidiaries. There is only one little difficulty. It is 8 cents a pound more than the identical hamburger that can be bought anywhere of equal quality and subject to the franchisor's specifications.

I don't know if you know how many hamburgers go through a typical fast food franchise, but at 8 cents a pound, that's a lot of money. That's aside from the royalties, aside from the contribution to advertising. It's aside from the purchase price to obtain the franchise. It's aside from everything else that usually occurs in a fast food franchise. Indeed, the same franchisor is now exercising its asserted power to eliminate other businesses that the franchisee may wish to enter. The franchisor is doing so without any legal authority contained in the written agreements—indeed, under a written agreement which the Supreme Court of your State has held illegal. I don't know if you want to ask. Ask publicly or privately, at will.

One of the other sore spots that I bring to your attention has to do with field supervisors. These men and women operate with plenary authority, far in the field and far away from the source of power. A few years ago I received a phone call from a large automobile dealer of one of the major big three auto factories. He said, Mr. Brown, you've missed a big point. I said what is it. He said I've been such and such a dealer for 15 years now—the call was from Atlanta, GA, by the way. He said, you don't know how it is to suffer under a zone manager who is an alcoholic, who after his luncheon cocktails is incoherent.

So I wrote a letter to Automotive News and asked how a major factory can allow zone managers, with their plenary power, to operate, even though they are probably ill and need medical treatment. Within the next 9 months, close to 200 zone and district managers of that company were led into early, early retirement.

About a year later I received a call from the same dealer. He said I read in the Wall Street Journal about how all those alcoholic zone managers and district managers were pushed into early retirement. I said, isn't it wonderful. We did it with one letter. He said, there's only one problem. I said what's that. He said they missed my guy. So I wrote another letter, and another 100 or more zone managers were dismissed.

Now, we did something. That particular company—a wonderful company, by the way—immediately responded to a challenge that it had never recognized, that is, the problem of field supervisors. We're not talking about executive, directors, vice presidents, and other senior officers. These middle managers, the field supervisors, have the real power. Virtually none of them are subject to any supervision.

Is that unique or unusual? No; you can read the case cited on page 4, *Dunkin' Donuts of America, Inc.* v. *Plocar*, where a female field supervisor forced a franchisee's minor son into unusual sexual behavior. The response was that the franchisor could not possibly have foreseen the risk and, therefore, should not be liable. The decision is correct. The problem is nobody sees the problem from the perspective of the franchisee. Nobody sees the need for an independent way for franchisees to bring serious problems to the attention of franchisors and to get a plain, quick, and fair hearing on the endless, endless abuse to which they can be subjected and to which they may daily be so subjected.

Franchisors can be extremely bold in exercising their claim of unconditional power to refuse to renew a franchise. I disagree with my good friend, Kathryn Boe. It seems to me that if a franchisee devotes 15, 18 years to building his local business, and then comes to the time of its sale, that he is entitled to a reasonable opportunity to make that sale.

Now, let me tell you what happens, and is happening this minute. Let's take for this supposition a franchise of the most successful fast food franchise in the United States. We don't have to name it. It's now in its 17th year. It's doing about $1½ million in gross sales and it's netting $200,000. It has a putative resale market value of $800,000 to $1 million. But it has 3 years to go. There is no fool in the world who will pay $1 million for that franchise that only has 3 years to go without some assurance of renewability, except for good cause.

Now, the person who controls the renewability is the franchisor. You may say well, won't the franchisor renew? Well, let's see what they do. Number one, the franchisor sells franchises. Therefore, it is a direct competitor of the franchisee who would like to sell the franchise. The franchisor recaptures franchises from failing or unable franchisees, rehabilitates them and resells them. The franchisor deals in the capital asset market in every way that is conceivable and is therefore a direct, active competitor of the franchisee. All that the franchisor has to do is suggest to the buyer that he may be paying too much. That kills the sale. The franchisor can then sell another franchise to that same customer. Indeed, the franchisor can just remain silent because, without a positive chance or hope of renewal, the buyer will not go through with the sale.

Now, according to Dean Kathryn Boe's philosophy, there is nothing that the franchisee had to sell. There are 3 years to go and then it is all over. Please let me tell you that there are 500,000–600,000 franchisees out there by the count used by the Department of Commerce. By my count, there are approximately 2 million franchisees out there. Those franchisees know that they have developed local good will, that they have done the job that had to be done, and there is no way that you, Kathryn Boe, or any legislator is going to tell those franchisees that they don't have a right to continuation so long as the are doing their job correctly.

That has now been recognized in 13 important States of our Union. There is a slight error in the list in my written presentation. But 13 of our major States, including Illinois, California, North Carolina, and others, have provided by statute—they have

crystallized the philosophy that I have suggested to you—that unless there is good cause for nonrenewal, the franchisee is indeed entitled to renewal. Now, in my opinion, that's the way society has to balance things out.

In point of fact, aside from such statutes, when we are confronted with this challenge in private practice, we have developed other ways to accomplish that result. My written materials will provide you with some of the ways we have devised to achieve justice and fair play.

Mr. PRICE. Fine; we will put your full statement in the record. We do need to wrap up fairly quickly, as our time is limited.

Mr. BROWN. If you would like me to comment briefly on some of the disclosure matters, I would be happy to do so, or I can leave them to my statement, as you wish.

[Mr. Brown's statement may be found in the appendix.]

Mr. PRICE. Why don't we move on now to some questions. I imagine that these matters will arise, and also Chairman Eckart and others may have questions which they will ask you to answer in writing.

Let me turn to Mr. Kostecka first. It is my understanding that the Department of Commerce data is the only available data on the extent of franchising in the economy, and the statistics, of course, have been cited by a number of witnesses this morning. I also understand that the Office of Management and Budget has disapproved of this information collection and has decided not to budget the Franchise Division of the Department of Commerce. The end result, of course, would be no statistical data at all on the franchise industry.

First of all, is that true, and if so, what is OMB's possible rationale for this?

Mr. KOSTECKA. It's not that they didn't fund it. When you survey more than 10 different companies, you have to get permission from OMB to collect data. Every 3 years we have to submit a request for permission to conduct such a survey with OMB, and they give us permission for 3 years. Now, we've been doing that for 17 years.

This year it was rejected because of four different reasons that the specialist at OMB has given. The first reason he said was the information collected fails to demonstrate practical utility. I didn't quite understand that because we sell 7,000 copies of the report annually and it's demanded by educators, franchisors, franchisees, and sold throughout the world.

The second reason he gave was that ITA, which I'm a part of, the International Trade Association, already collects and publishes this information in their Franchise Opportunity Handbook, which is not true, because the Franchise Opportunity Handbook just lists the franchise offerings of franchisors.

Mr. PRICE. Excuse me. So the Franchise Opportunities Handbook does not contain statistics which——

Mr. KOSTECKA. No statistics whatsoever. It contains a listing of franchisors who want to sell their franchises to any potential entrepreneurs, and other information. But there's no statistical information.

The third reason that he gave was that the information collected has no direct application to Federal policymaking, since the Feder-

al Government does not regulate franchisors or franchisees. The report "Franchising in the Economy" has been used by the SBA, the FTC, Justice Department, and it has been constantly used by congressional committees in reviewing franchising legislation.

The fourth reason they gave was States and businesses using this data have been doing so at Federal expense and should therefore bear the cost. Well, actually, if you look at the cost of conducting the survey, it costs about $20,000 to conduct the survey, and with the sales at 7,000, actually the Federal Government makes a profit. So there is no cost to the Federal Government to conduct the survey.

No single State could ever justify a national survey because franchising is a commercial activity inherent in interstate commerce. So those are the four reasons that it was rejected.

I have been trying since November and have sent a memo for reconsideration. It has to go through a number of people, I think eight different individuals, before it gets back to OMB. It lay on one person's desk for 7 months.

Mr. PRICE. You submitted this request for reconsideration when?

Mr. KOSTECKA. Last October. It lay on one individual's desk—who, incidentally, is leaving the Government at the end of this month—for 7 months. Now it's above him. Actually, it's not written the way I wrote it originally. He suggested that the survey should be privatized.

Mr. PRICE. We've heard that before, haven't we?

Mr. KOSTECKA. The survey cannot be privatized. I mean, many things can be privatized, but I think the Federal Government is the only one that can really collect confidential data of this nature. I have seen many organizations attempt to do surveys like this and their response rate has been very, very poor. To collect confidential data from the franchisors, it has to be done by a Government agency.

Mr. PRICE. So the status of this request is that it's still pending?

Mr. KOSTECKA. It's still pending.

Mr. PRICE. Meanwhile, have your data collection efforts been?

Mr. KOSTECKA. It's at a standstill, zero. I cannot collect the data.

Mr. PRICE. We've had some questions raised, of course, about methodology and about some of the fine points of this data collection. What I haven't heard all day, though, is any suggestion that this data could be dispensed with, or that this data was somehow irrelevant or that there were alternative sources that could readily be tapped.

Mr. KOSTECKA. There is no alternative sources. In my opinion, this will be a disgrace to eliminate the survey because there will be no statistical information available on the franchise industry.

As you have heard here, franchising is really a very important part of the U.S. economy. It creates over 7 million jobs. We're talking about sales of $640 billion. By the end of this year, franchising should account for 34 percent of all the retail sales in the United States. So we're talking about a system of distribution that is really a very important part of the U.S. economy.

In addition to that, as a result of American franchisors, franchising has grown rapidly throughout the world. American franchises are expanding more rapidly in worldwide markets than they are in

domestic markets. We have today 354 U.S. business format franchisors operating practically in every country in the world. Many of our franchisors can use the phase that the sun never sets on their franchise.

Mr. PRICE. I wonder if any of our witnesses, either on this panel or the previous one, would agree with OMB's assertion, that this data collection fails to demonstrate practical utility.

Mr. Fox, do you agree with that?

Mr. FOX. Of course not.

Mr. PRICE. Professor Kellman?

Mr. KELLMAN. No.

Mr. PRICE. Ms. Boe?

Ms. BOE. No; as a matter of fact, this data is useful not only to franchisors but prospective franchisees, because the data allows you to identify trends in industry. So if they're considering one kind of franchise that the data says is going downward, they can switch their focus to another kind.

When I look at the other kinds of publications which we are funding right now, it's extraordinary that we're considering not continuing to fund this. I noticed on the shelves yesterday, for instance, new studies on whales and porpoises in the western North Atlantic, right next to extensive studies on living conditions required by human beings for extensive periods in outer space. At the rate we're going right now, I'm not sure how many Americans are going to spend much time in space, but I can tell you that more than half-a-million of them are franchisees now, today.

Mr. PRICE. Mr. Brown?

Mr. BROWN. I agree with what has been said.

If I may provide a modest legal footnote in favor of the continuation, the Supreme Court of the United States has ruled that the giving of false information that is used for statistical purposes is subject to the Federal crime punishment of 5 years or a $10,000 fine. That decision means any fraud in connection with anything done by the Government is punishable. So that in soliciting the information that is held confidential, people don't have to worry about its being given out, but if they give false information, they are really subject to some severe penalties. Nobody but the United States can exercise that power.

Mr. PRICE. We have some of our first panel witnesses still in the room. Let me ask them.

Would any of you agree with OMB's position that this data has no practical utility or that it's irrelevant to Federal policy making? Mr. Simon, how do you feel about that?

Mr. SIMON. I think it's absolutely vital that the Department of Commerce continue publishing it. It's very important information.

Mr. PRICE. Ms. Taylor?

Ms. TAYLOR. I think it's important information, but I would raise some serious questions about the methodology. I know a lot of——

Mr. PRICE. Well, that's not what we're talking about. What we're talking about is whether it's appropriate for a Federal Department to collect this data.

Ms. TAYLOR. I think it is, but there has to be some reservations because this data is used extensively by franchisors in soliciting

sales. Many times it is used out of context and is given credibility by the fact that it came out of the U.S. Department of Commerce.

The second thing I would add, as far as the list of all franchisors, it is often used as a sales tool, for instance, where it's advertising here is a list of franchisors who you could purchase franchises from. I believe, in fact, that might be something that belongs in the private sector. But I do think it's useful for the U.S. Commerce Department to compile methodically sound statistics.

Mr. PRICE. So your complaint is with some of the methodological assumptions and so forth; you're not questioning the importance of collecting the data.

Ms. TAYLOR. No.

Mr. PRICE. You're not suggesting, are you, that there is some alternative source of data that is readily available that would render this unnecessary?

Mr. TAYLOR. No; but I would raise serious questions about the methodology.

Mr. PRICE. I understand.

Mr. Kostecka, I appreciate your filling us in on this, and also your willingness to go into some detail in answering the OMB charges. I'm sure the chairman and other members of the subcommittee will want to follow up on this situation.

Our time is limited. Let me pose a few questions and then, as I say, we will want to keep the record open and give other subcommittee members a chance to submit questions to you. You've been very patient and I appreciate your bearing with us through all the votes and the delays, so we will try to wrap this up pretty quickly.

Professor Kellman's testimony stressed the need to take a fresh look at the question of termination. You suggested that perhaps, instead of laying down elaborate conditions and restrictions on termination, that some kind of insurance of fair compensation might be a more adequate statutory approach.

Mr. KELLMAN. That's correct.

Mr. PRICE. I gather you do think such a statute would be desirable at the Federal level?

Mr. KELLMAN. Definitely at the Federal level, for much the same reasons that Kathryn Boe brought out, the need for uniformity.

Mr. PRICE. Mr. Fox, you spoke rather negatively of the idea of a Federal statute that would put elaborate conditions on termination. I wonder if you've considered Professor Kellman's idea and what your reaction would be to that.

Mr. FOX. I have a number of reactions, and I'll try to be very brief.

The fact that it's been around for 20 years and not much credence has been given to it tells me a little about its merit.

Mr. PRICE. What has been around for 20 years?

Mr. FOX. This notion that was initiated by Senator Hart back 20 years ago. But that's not really the important point. The important point to me is that it's a confusion of apples and oranges once again. If you are building a business of your own, you build equity. If you are purchasing a license, which is what is being done here, and that license is for a specific term, then, unless you're willing to change licensing law completely around, there is simply no way

you can have, under existing law, an equity buildup. It comes to an end.

Now, it is conceivable that you could have legislation affecting this one kind of trademark license and say, in the context of franchising, you could build up equity, but it certainly stands trademark law right on its head. My reaction is very negative.

Mr. PRICE. Ms. Boe?

Ms. BOE. I have the same reservation. We have talked about characteristics of a franchise very generally. But at its heart, a franchise is a trademark license. The other characteristics vary from one statute to another. As long as we're talking about a trademark license of a specified period of time, it becomes very difficult, if not impossible, by definition, to try to evaluate a business the way Professor Kellman is suggesting to us.

We have an underlying problem here that keeps coming back to the fact that you negotiate the term of this deal at the start. The terms for renewal are laid down very openly at the start. You can change any of those things or, if you can't change them with this man, you vote with your feet by switching to another deal offered by another franchisor.

Mr. PRICE. Professor Kellman, how do you respond to these comments? In particular, is the question of valuation an insurmountable problem? How do the precedents in other areas of the law cut in this particular case? Do you agree with Mr. Fox's assessment?

Mr. KELLMAN. I think we have a number of questions on the floor. I don't think the question of valuation is an insurmountable problem. I don't see it as any more difficult—in fact, I see it as a good deal less difficult—than the measure of damages in wrongful termination litigation. As I began my testimony, I think we see an analogy when we talk about corporate stock redemptions.

But I would like to respond to the comments that have been made by Mr. Fox and Ms. Boe just now. I think they highlight the problem exactly. I think their comments are exactly right for the position which they are advocating, and I think this subcommittee has to make a very fundamental choice. If franchising is perceived as a contractual transaction involving the licensing of a trademark—of course, it is that—but if it is perceived as exclusively that, then obviously my proposal goes too far.

The essence of my proposal, or I should say the starting point of my proposal, is that what we have here is a far more complicated business relationship, in which people invest not only, as Mr. Brown pointed out, great quantities of money, but they invest very substantial portions of their lives. To say they don't have equity in that because all we have here is a transaction involving a trademark, to me denies the essential human component of this system that we're talking about.

What I am trying to suggest to the subcommittee is that the realities of franchising are that people don't walk to the negotiating table on an equal footing; people do not have absolute freedom to take and to walk and to develop contracts that serve their best interests; there is not a parity of bargaining power. That bargaining power changes over time to the greater advantage of the franchisor. Therefore, Federal law should recognize the very real implications of termination of that relationship on the franchisee.

Mr. PRICE. Mr. Brown, do you have any comments on this general line of discussion?

Mr. BROWN. A great deal.

Mr. PRICE. Briefly, please.

Mr. BROWN. I'll make it very brief. First of all, the Federal Government has recognized the interest of franchisees in the largest segment of this whole business, the gasoline service station dealers in PMPA. The unfortunate thing is that PMPA, the Petroleum Marketing Practices Act, has so many other problems that this otherwise clearly-stated right is somewhat beclouded.

I have also indicated to you that 13 State legislatures, covering about 40 percent of the people in this United States, have likewise so acknowledged. In perfect Brandeisan logic, their decisions, hundreds of State legislators, with their Governors, are declaring a policy as loudly and effectively as any that I know.

I also call upon the U.S. Constitution, which says the U.S. Government, the Federal Government, should stay away when States are dealing with matters that are primarily theirs. This is primarily a matter for State law.

I will just give you one case that demonstrates that the argument being proposed against renewal is fallacious. It's the case of *Miskimmen* v. *The Kansas City Star*, where the dealers, having lost a complex antitrust suit, sued in the State court. They all had a written contract; it said they could be terminated by the franchisor on up to 30 days' notice, with or without cause. In extended litigation, and after an appeal, it was held the Kansas City Star was estopped to rely upon that express contractual right by reason of its conduct, its representations, and its dealing with the dealers. The case, incidentally, was then settled for $27 million.

Now, this case proves that the concept that franchising is nothing but a contract is completely wrong. While I object to the Uniform Commissioners' legislative proposal its uniform concept is that there is a duty of good faith and fair dealing and that the duty permeates the entire relationship. I am seriously disturbed by those who would put the tenure issue solely in the power of a franchisor, giving it the unilateral power to prescribe the duration of the contract, 7 days, 30 days, 5 years, 10 years, 20 years, or whatever. It's not the relevant source of the rights of the parties.

I will also tell you that we litigate this issue and we win them on a wide variety of legal theories. I think the judges and the juries that rule in our favor are saying something more loudly than what you are hearing here today. You're hearing a narrow segment of deductive reasoning as to what this is by way of a contract. I'm trying to persuade that that is not so. Unless you adopt a Federal law that preempts all State laws on all subjects—and I challenge your power to do that—you're not going to beat the effort that franchisees and their attorneys have been trying to demonstrate and have successfully demonstrated in important States across the land. Thank you.

Mr. PRICE. Ms. Boe.

Ms. BOE. Congressman Price, I think it's important that we realize first the scope of some of these problems, and second, the remedies available for some of these problems.

The area that tends to be a focus for us is termination, or nonrenewal area specifically. Remember that we're probably dealing with 3 percent of the franchises that are available for renewal, which are not renewed exclusively at the option of the franchisor. That's a very small number.

Now, aside from whatever statute you propose or don't propose on the Federal level, the franchisees have available at their disposal now all sorts of common law theories that Mr. Brown uses very effectively in taking care of them. It isn't that a franchisee has lost all his other rights. He still has his rights under contract law, constitutional law, tort law, tax law, corporation law, agency law, and any others that you learned in law school.

Mr. PRICE. Professor Kellman.

Mr. KELLMAN. If I might, I don't think anyone in this room knows the numbers of what we are discussing. If I might commend to the subcommittee, that might be the first order of business, to get some handle on how severe the problem is. My sense is that it is serious enough to deserve some consideration.

Mr. PRICE. Let me ask at this point one clarifying question, though, which was brought up by Mr. Brown's statement. Are you suggesting this kind of fair compensation measure as a State statute, or are you suggesting there might be some kind of preemptory Federal statute that would establish such a condition?

Mr. KELLMAN. My entire vision of franchising is that it exists in interstate commerce. I could be informed as to statistics, but my sense of franchise networks is that they are almost invariably in interstate commerce. My view is that it would be better for franchisors and franchisees and for the consumers to be dealing with one unified system.

Mr. BROWN. If it please the chairman——

Mr. PRICE. Mr. Brown, I gather you disagree with that.

Mr. BROWN. Let me just give you one citation. The State of Maryland ruled otherwise, and all the major oil companies, particularly Exxon, challenged the State statute on this issue, and all the oil companies lost. The U.S. Supreme Court held this is a matter for the States. The commerce clause does not preclude State legislation. This has been ruled upon.

I'm dumbfounded that now, simply because there are lots of franchises in lots of cities, that it can be suggested that a State statute is unconstitutional because it involves interstate commerce. That constitutional preemptive only precludes State legislation that discriminates against interstate commerce. What about *Maryland* v. *Exxon*? That answers your question.

Mr. PRICE. All right. Let's assume, at least, that the question is clearly framed and move on. I cannot resist any longer asking you about the hamburger case. Of course I would like to know what specific situation you're talking about.

Mr. BROWN. The name of the franchisor is Hardee's, and I represent Bodie Noell, which has 275 franchises of Hardee's. It is forced to pay 8 cents a pound for hamburger above the price for absolutely identical hamburger that can be bought from many qualified suppliers.

Under the antitrust laws we no longer can pursue that sort of a tying violation because this administration has succeeded in deci-

mating what we used to call anticompetitive policy. This is, nonetheless, an unfair practice which the Federal Trade Commission could, if it wanted to, but won't, attack as an unfair act or practice. We are attacking it and shall continue to do so under State law.

Mr. PRICE. So you're not suggesting that there is some deficiency in either State or Federal law that leaves this problem uncovered?

Mr. BROWN. It relates to the question of the power to terminate or fail to renew without good cause, because that is the sledge hammer that permits franchisors daily to force arbitrary and whimsical decisions. It isn't a question of the 3 percent, which may or may not be the correct number, that don't get renewed. It's the 500,000 who daily live under total compulsion without freedom of action.

I have just given you one. It's as close to home as Rocky Mount, and I'm sure you've been there.

Mr. PRICE. I'm well aware of it, that Hardee's is a North Carolina company.

How common is this kind of marketing requirement?

Mr. BROWN. It's pervasive, and the way they used to try to avoid it in the contract was to say, under the antitrust laws, we'll give you the specifications if you'll let us test the product, and they delay endlessly and never respond and never make it available.

Mr. PRICE. When you say pervasive, can you be more specific? For example, among fast food franchises.

Mr. BROWN. Well, let me take that same franchise. They are required to buy all their equipment from the franchisor. You can't get approval of any alternative sources of supply.

Mr. PRICE. Is that the general practice with Burger King and McDonald's and the various other——

Mr. BROWN. It is not a general practice. The variables are incredible. Let me take Burger King, because you said the word. A client of mine just bought a Burger King franchise and paid $1 million for the real estate and the fixtures, whereupon Burger King opened a store 2 miles, 2 minutes, away, and is destroying his franchise.

Now, why do they get away with it? Because they have the power of renewal and the power to threaten termination. I'm telling you that these are cases that we are litigating today. These are current practices. This isn't old history that is now forgotten. The names that I am mentioning to you are the most reputable in the business.

Mr. PRICE. I suppose the question we would need answered by you is whether the statutory base on which you're conducting this litigation is adequate. In other words, apart from a series of alarming examples, what are we supposed to conclude in terms of the gaps in the law and the kind of——

Mr. BROWN. One major gap, which has been addressed in a Harvard Law Review article, by the way, is the fact that little Federal Trade Commission Acts do provide the private cause of action that has been denied to the Federal Trade Commission. The FTC has requested it and specifically requested it for enforcement of its presale disclosure rule. The State courts and the Federal courts just haven't interpolated a private cause of action to enforce the rules of the FTC.

Now, the Federal Trade Commission, up to the current one, has repeatedly asked for the availability of a private cause of action to aid in the enforcement of its policies. That is something that the Federal Government should seriously consider. At least every State has some form of a little ITCA but a minority number of States allow private suits. The States that have it in correct form are Texas, Massachusetts, North Carolina, and many others—North Carolina was one of the first States to adopt an appropriate statute. There are only about 14 States that make that kind of private remedy available.

You have the power, Congress has the power, to grant what the FTC has recommended specifically for the enforcement of the presale disclosure rule, and that is a private cause of action.

There are other things that can be done, but that is one of the principal means that we use. We employ remedies that at the forefront of the common law, matters like estoppel used in the *Miskimmen* case, and promissory equitable estoppel used in the case against the Hearst papers. These were successful cases. These are the ones that are successful. We have many other avenues to use to remedy overbearing conduct. But that's a difficult and hard thing for franchisees to do, and neither we nor they should have to litigate. There should be a clarification so that all litigation can be eliminated, so that we have a reasonable basis for living together successfully.

Mr. PRICE. You're not suggesting that all requirements that a franchisee purchase from the franchisor are totally unacceptable and illegitimate?

Mr. BROWN. They are totally unacceptable in this sense: The franchisor has, and should have, the absolute power to set the standards and specifications. If it wishes, the franchisor should have the power to make available all of those products available to franchisees who want to purchase them. The franchisor should have the power to approve alternate sources of supply that satisfy its specifications and standards. But they should be compelled to exercise that power reasonably. When a request is made for permission to use an alternate source, and you have to wait 3 years for an acknowledgment that you have written to the franchisor, that's too long. When franchisors ignore such requests or take too long to respond or never grant permission for alternate sources, then it is clear that they have broken the terms of their franchise agreement and that their express representatives in their presale disclosure documents are deceptive, such conduct is illegal as unfair, deceptive acts, and practices.

Mr. PRICE. Mr. Fox, do you have a quick response on that specific point?

Mr. Fox. The last point, I couldn't agree more, the tying of one required purchase into a system where the franchisee is forced to take other things. What I'm saying, in a nutshell, is we have tying arrangement laws on the books. I know Mr. Brown doesn't like what the Supreme Court has said about them in recent years, but they are there and they serve as the basis for winning litigation in situations such as the one he described, which I believe is as outrageous as he thinks it is.

Mr. PRICE. Fine; I'm sorry that we're going to have to call this to a halt. In particular, I wanted to explore Mr. Fox's suggestion that there was some kind of correlation between the extent of State regulation and the health of franchising in a given State, based on the Michigan example. I wonder if there are not some counterexamples and I wonder how far you would want to take that suggestion, that there is some kind of correlation between the content of State law and how well franchisors have fared in those States.

This and other questions, though, I'm afraid we're going to have to leave for the record. As I suggested earlier, we may be sending some of those to you because, unfortunately, the chairman has been called away by some heavy action in the Energy and Commerce Committee, and other members have not been able to be here as well.

I do appreciate your patience and the seriousness and comprehensiveness of your testimony. It's been a pleasure to have you here. We will no doubt be in touch with you as we continue looking at these matters. Thank you very much.

[Wherupon, the subcommittee was adjourned, subject to the call of the Chair.]

APPENDIX

Fresno, California 93710
Telephone 209 227-8315

United States House of Representatives
Committee on Small Business
Subcommittee on Antitrust, Impact of Deregulation, & Privatization
August 4, 1998

My name is Jack Jensen, and I would like to thank you for the opportunity to participate in this hearing regarding the business format segment of the franchise industry.

My brother, Reynolds Jensen, and I are currently Taco Bell franchisees in Fresno, California. For anyone who might not be aware, Taco Bell is a member of the PepsiCo family of restaurants, which also includes Pizza Hut, and most recently acquired Kentucky Fried Chicken. Taco Bell has approximately 2700 Mexican quick service restaurants, of which approximately 1500 are company owned, and 1200 are franchised.

My brother originally worked for Glen Bell who founded Taco Bell. In 1965 he worked as a franchise consultant opening new restaurants while he was waiting for his first franchised unit to be built in Fresno.

BEST AVAILABLE COPY

Prior to becoming a Taco Bell franchisee, I had been a multi-unit independent tire dealer in the Ann Arbor-Detroit, Michigan area for the previous sixteen years.

I joined my brother in 1981 at a time when he had increased from one unit to five.

My brother and I had kept in very close contact throughout the years, and he had determined the atmosphere, and timing was right to become very aggressive, and open new units as fast as possible, so we could be the dominant Mexican quick service restaurant in our Area of Dominant Influence (ADI). We had envisioned twenty to twenty-five units would accomplish this goal. With that vision in mind, I proceeded to dispose of my business interests in Michigan, and prepared to relocate to Fresno.

We approached Taco Bell with our plans, and were enthusiastically encouraged to proceed. I submitted my application, and financial information, and was accepted into the franchise community.

At this point I would like to give you a short outline of the sequence of events that I will be discussing in the remainder of my presentation:

1. Entering into the System
2. Proceeding with Development
3. Upgrading of Existing Units
4. Changing of Agreements
5. Obtaining and Discharging of Legal Council
6. Amending Agreements
7. Deterioration of Relationship
8. Involvement in National Association
9. Non-Renewals
10. Cannibalization

We immediately proceeded to secure property and by April of 1982 opened our first joint unit. The next in July, 1982, and our third in September, 1982. Our plan was well underway.

1983 proceeded well with the opening of three additional units, as well as the same for 1984. However, the relationship was becoming more strained because of the increasing demands being placed on us from corporate.

The demands were in the form of equipment and decor changes in existing restaurants before we would be favored with another units. In some cases it grew to a million dollars of upgrades to obtain one more unit. In a twelve month period between 1984 and 1985 our upgrading expenditure approximated $800,000.

Another common tactic that was being used was for the franchise consultant to do "shoppers reports" on a few units, and give them failing scores. Thus rendering us operationally unapproved for growth. However, once you complied with the shopping list of upgrades, we would become operationally more proficient, and then favored with one more unit.

At the end of 1984, the company determined that it would be in the best interest of the system to institute a new fee restructure policy that was far more favorable to the company and less favorable to the franchisee. At this point we had several different agreements in effect, however, in all cases the terms did not seem to be in our best interest. This was the beginning of a long period of

The proceeding months became a real nightmare of negotiating while getting legal council involved.

Apparently when a franchisee looks for outside assistance from legal council you have committed a form of "Harry Carey" much the same as when the news gets back to corporate that I am participating in this exercise today.

After several months of soul searching, we chose to dismiss our legal council, and try to come to terms with a program that was somewhat reasonable without giving "away the farm".

On March 17, 1985 we met with the "powers that be" at corporate, and proceeded to negotiate what we felt was reasonable at the time. Mind you, there was extreme pressure being placed on corporate personnel to bring all non-conforming franchisees into line.

We agreed to amend all of our contracts in exchange for the immediate approval for the three units that were in place, plus five additional units, and the assistance of corporate in changing the voting structure within our advertising association to better reflect our contribution, which at that time was approximately 70% of the funds. We were only

asking to make it commensurate with the voting rights that corporate has in the geographical areas in which they are the predominant contributors.

After signing the Fee Restructure Agreements, we immediately began construction on the three units, and proceeded as orally agreed. In fact, at this point in time Fresno was the only major market in the Nation where there were more Taco Bell restaurants than Mc Donald's. Within ninety days, all that had been orally agreed to was now a commitment that was not to be honored.

Once again we went back to legal council, and a long period of frustration. It was also a time that one of our supervisors was sold a franchise to open a unit at a location that was part of our plan, and the entry of another new franchisee into the system opening on two additional locations that were also in our plan.

Also, it should be noted that we were able to prevail, and stop the development of another restaurant that was proposed by a new franchisee that was to be located in the middle of an area in which we are currently operating eight units within a three mile radius.

It seems that we have now been put in a position that outside competition is not our greatest fear. It is the fear of having to protect ourselves from the people we send $20,000. per week to for the privilege of being a Taco Bell franchisee.

Concurrently at this time an organization named the "National Association of Taco Bell Franchisees" was being revived because of mounting problems within the franchise community.

In search of a forum in which we could have some input into improprieties that were occurring, we chose to get involved. At the next National meeting I was elected vice president. Shortly after that the president incurred life threatening health problems and had to resign, therefore elevating me to president, of which I have since been re-elected. However, again, this is not a forum that Taco Bell corporate will recognize, or communicate with.

The concerns of NATBF were that of cannibalization, forced expansion, renewals, and forced equipment purchases. I addressed these concerns to John Martin, President of Taco

Bell in a letter in May, 1987. The letter had been constructed by a committee of franchisees, and NATBF's legal council.

In response I received a short two paragraph letter from Taco Bell's general council stating that our concerns were unfounded, and they were considered as "bald acts of treachery". As a member of the National organization I have been labeled a dissident, sabre rattler, and rabble rouser, just to name a few.

I must digress for a few moments to touch on another area of concern by your committee, and that is of renewals. We had increased operation to eighteen units, but because of non-renewals we have decreased to seventeen units, and soon to be sixteen units in the Fresno, California area.

In April, 1986 Taco Bell forced us to close the first unit that my brother had opened in 1966. This occurred after we had amended our agreements, and increased the fees in this unit from 2% weekly to 10%. A renewal was offered to us, however, it was offered with the stipulation that we had to build a new current Taco Bell restaurant on this same location. No alternatives were given. We could not comply

as the square footage of the lot was a mere 16,000 feet. To construct a building of the current design it requires a minimum of 28,000 sq. ft., and works best with 32,000 to 35,000 sq. ft.

That restaurant in its last full year of operation netted in excess of $100,000. and was well above the national average in sales. There is also a side note, that it was one year after the closing before we receive a $4,000. non-interesting bearing deposit that had been made in 1965.

Now, coming to August, 1988, and the second unit is being closed on August 30, 1988. No successor agreement has been offered, or has any letter of explanation been forth coming as to why it is being closed, or has any alternate location been offered.

I have been informed by a source very close to the president of Taco Bell that we will never get another unit, another renewal, or would we get favorable consideration should we attempt to sell. This is probably fact, as this has happened to other franchisees that I have been in contact with through NATBF.

This puts the franchisee in a position of owning a diminishing asset without being able to sell on the open market. This is a result of Corporate maintaining the right to disapprove any potential buyer a franchisee may present, without giving a reason for that disapproval.

Also to be considered is the fact there are "non-competing" clauses in the agreements which preclude a person from entering into any kind of quick service restaurant that in any way would compete with Taco Bell. However, the same consideration does not prevail within the PepsiCo organization, as they have, as reported in the most recent annual report, 13,000 Pizza Hut and Kentucky Fried Chicken units that most definitely compete with Taco Bell for the fast food dollar.

Thank you for the opportunity to present an individual franchisee's situation in dealing with the mega conglomerate franchisor. I have volumes of pages of documentation, and correspondence to substantiate these statements, as well as the claims of other franchisees who have shared and confided in me with their problems.

Should the direction of your committee have the need to be more specific, please feel free to contact me. If anyone should have any questions, I am open at this time.

Fair Franchising Coalition
1725 K Street, N.W.
Suite 308
Washington, DC 20006

Telephone: (202) 775-1135
Facsimile: (202) 785-1978

TESTIMONY OF

MICHAEL J. WILD

FAIR FRANCHISING COALITION

BEFORE THE

HOUSE SMALL BUSINESS

SUBCOMMITTEE ON ANTITRUST,

IMPACT OF DEREGULATION AND PRIVATIZATION

ON

AUGUST 4, 1988

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AUGUST 4, 1988

Good Morning. I am Michael J. Wild, representing the Fair Franchising Coalition, and I want to first thank the Chair and members of the subcommittee for the opportunity to present our views before your committee today. I am President of Re-De Equipment, Inc. of Brooklyn, New York, and past president of our trade association, the Independent Medical Distributors Association (IMDA). Accompanying me today is Mitchell Kramer, Esquire, a Philadelphia attorney specializing in franchise law.

The Fair Franchising Coalition is a national group of franchisees, manufacturers' representatives, distributors, and other marketers that supports efforts to obtain fair and reasonable treatment from their suppliers.

Coalition members include:

Association of Industry Manufacturer Representatives

Committee to Support the Antitrust Laws

Independent Medical Distributors Association
Health Industry Representatives Association
Institute of Certified Business Counselors
National Alliance of Franchisees and Dealers
National Coalition of Petroleum Retailers
National Graphic Arts Dealers Association
Organization of Manufacturers' Representatives

With the rapid growth of franchising and similar marketing arrangements, virtually every line of consumer business uses franchising to sell products. Nearly one-third of all retail sales are generated through franchises. According to the Department of Commerce, franchise operations sell about $576 billion in goods and services annually and employ roughly 5.7 million people in the U.S. In addition, reps, agents and other wholesalers generate nearly $2 trillion in annual sales and employ nearly 5 million people. Many small business franchisees and reps simply do not have the means to deal with the tremendous market power and control of franchisors.

Thus, more and more companies rely for their existence on a franchisor or a manufacturer.

The problems of franchisees, manufacturers' representatives and distributors are similar. They are small businesses which can be put out of business at any time by the franchisor or manufacturer which supplies the products and the nationally recognized trademark which these companies need for their survival. Often these companies' survival depends on the whim of a

vice president for franchise relationships or a national vice president for sales and marketing.

In this statement I will refer to the traditional franchisee (for example the 7 Eleven store owners) as well as the manufacturers' representative and the distributor as "franchisees." The life blood and survival of these companies depends on the products which they distribute. By the same token, the existence of much American industry depends on the ability of these franchisees to sell their products to the consuming public.

The days of the manufacturers' representative or distributor who operates out of a suitcase or the trunk of his car are gone. Today these companies maintain large and growing organizations which require sophisticated central and regional offices, sophisticated communications equipment, computers and, in many cases, warehouse operations.

Franchisees have a contract which is either written or oral with a franchisor or manufacturer. Manufacturers' representatives and distributors generally have contracts which either are terminable at will or terminable without cause on 30 to 90 days notice. Traditional franchisees generally have longer term contracts, but those contracts are terminable for cause and usually cause is defined very broadly in favor of the franchisor.

The result of contracts which give the franchisee no real stability is the fact that over four million jobs rely on the goodwill of people who have never met the employees. Moreover,

it is difficult for franchisees to plan for orderly expansion or to obtain adequate financing for operations and expansion when their very existence hangs on a thread. While franchisees may attempt to negotiate longer-term contracts, generally, manufacturers offer contract on a take it or leave it basis. The bargaining positions of the franchisee and the franchisor are, obviously, unequal.

By enacting the Petroleum Marketing Practices Act, 15 U.S.C. Section 2801, et sec., and Automobile Dealer's Day in Court, 15 U.S.C. Section 1221, et sec., Congress recognized the need for remedial legislation which would establish certain guidelines for the relationship between the franchisor and the franchisee. These two industries represent only a small fraction of the "wholesale industry." The problems addressed by Congress in those two statutes are not limited to those industries, but is endemic to the entire area of franchisor-franchisee relations. There is a need for the federal government to enact legislation which addresses the problems confronting all franchisees, not only auto dealers and gasoline station owners.

A few states have recognized the problems by enacting legislation. However, most states have not provided any legislation in this area or legislation dealing with limited product markets. Even among the laws enacted there is inconsistency. Since most franchisors operate nationally or regionally, there is a need to bring uniformity to their relationship with their franchisees. The only way to accomplish such uniform treatment is through

federal action.

In addition, most of the franchise laws enacted in the various states focus on requirements of disclosure at the commencement of the relationship. In fact, Wisconsin is one of the few states which has enacted a statute designed to bring stability into the relationship of franchisees and franchisors. It has been my experience that despite the requirements of Wisconsin law, manufacturers have utilized agents and distributors in Wisconsin to the same extent that they have been utilized in other states. Furthermore, traditional franchisors have not hesitated to enter the Wisconsin market. Thus, it seems clear that the Wisconsin Act is not so burdensome that franchisors and manufacturers have been driven to find alternate means of distribution.

Mr. Kramer is currently representing a company that was a manufacturer's representative in the Chicago area. Despite the representative's ability to increase sales within the territory dramatically, it was terminated. Three days after the representative was terminated, the manufacturer announced that the replacement representative for the territory would be the manufacturer's national sales manager. The sales manager was the very person who terminated the representative. The representative's company went out of business, its employees were put out of work and the courts have held that in Illinois there is no remedy for the representative who is bound by the theory of employment at will.

In another situation, two distributors were terminated by a manufacturer because the manufacturer felt that the distributors were making too much money. The manufacturer then offered to employ the distributors' principals as salesmen. One of the distributors had built the manufacturer's sales in his territory from virtually nothing to over two million dollars in five years while the other distributor was selling over one million dollars of the manufacturer's products, again, from sales of almost zero five years before. Again, both distributors were put out of business and the federal courts ultimately held that the distributors had no remedy for their termination.

The Fair Franchising Coalition has documented other abuses in a wide range of industries. Ice cream franchises, photo equipment dealers, medical technology distributors, lawn equipment and hardware retailers and heavy equipment sales agents are but a few of the types of small businesses afflicted with the same kind of problem. The problems result simply from the inordinate power that franchisors, many of whom are among the largest corporations in the U.S., have over their far smaller and less powerful distribution outlets or franchisees.

This power results at the very outset in an unfair and unbalanced business relationship. I say at the outset because from the moment an entrepreneur initiates negotiations to purchase or take possession of a franchise or distributorship, he or she simply does not have access to the formidable resources that large corporations use to their advantage. The result: a nego-

tiations process that is not a real bargaining process.

In the vast majority of cases the franchisee has little or no bargaining power. Lawyers would hardly call this a contract negotiation: one party has all the power and the little guy either takes what is offered or leaves it.

That is why Fair Franchising legislation is important. It will give the franchisee, the small business person, a modest protection against unfair treatment. It will prevent the vicious tactics we have seen used by Southland from spreading to other industries. And it will, in the longer term, foster a stronger small business community, a healthier competitive climate, and increased productivity.

The rationale behind remedial legislation should be to require manufacturers to base their decision to terminate or decide not to renew a contractual relationship on good faith and fair dealing standards. Legislation should not inhibit legitimate business decisions made by manufacturers. Just as the Petroleum Marketing Practices Act allows for legitimate change and sets fair and reasonable standards for defining and terminating relationships among petroleum refiners and marketers, more general federal legislation should allow manufacturers to make legitimate changes in the relationship between the manufacturer and the distributor, franchises.

The Coalition supports a Federal Fair Franchising Act to redress long-standing problems in franchisor/franchisee and suppler/rep relationships. The Act would prohibit termination

without reasonable cause and requires that franchisors, suppliers and manufacturers treat their franchisees, reps and/or dealers fairly. The Federal Fair Franchising Act would provide small businesses with federal protection to prevent wrongful terminations and other abuses by franchisors and suppliers, and it would ensure that dealers/franchisees could sell/transfer businesses so as not to lose accumulated investments, under certain conditions.

Large suppliers, manufacturers, and franchisors often use termination, or the threat of termination, wrongfully or unfairly, to the disadvantage of the smaller business. Existing remedies firmly place the burden of proof and the expense upon the franchisee, agent, rep or dealer to demonstrate unfair trade practices or an antitrust violation. The burden of proof and expense of all these options rest clearly upon the small business, and often serve to create an unfair situation.

Unlike existing remedies, a Fair Franchising Act shifts the burden of proof to the franchisor or supplier to show sufficient reason to terminate or cancel an agreement. The Act requires the franchisor or manufacturer to state up front the reasons for termination, and assures that "the little guy" does not have to compete at an unfair advantage. The Act would help to establish a level playing field in franchisor/franchisee, supplier/rep relationships, and would create a uniform standard for business practices that are currently under the jurisdiction of a patchwork of statutes. In most cases, there is no remedy for termination of a franchisee's relationship without cause.

One of the proposed solutions to the problem of unfair termination is state legislation based upon the Uniform Franchise and Business Opportunities Act that has been developed by the National Conference of Commissioners on Uniform State Laws. This proposed legislation is the model state statute to address the problem of termination without cause and related problems.

This draft legislation is the result of a distorted drafting process that failed to address to concern of franchisees. Mr. Timothy Fine, a noted San Francisco attorney specializing in small business and franchise matters, served as an advisor to the commission. Recently, at the request of Washington, DC franchisees, Mr. Fine expressed his opinions on the Uniform Franchise and Business Opportunities Act:

I was the National Franchisee Advisor to the drafting committee on the Uniform Franchise & Business Opportunities Act and spent three years fighting the efforts of the franchisors in watering down this legislation. Unfortunately, the drafting committee wanted a bill so badly that they gave in to the very powerful franchise lobby in order to come up with something, no matter how weak.

Do not be fooled into believing the Uniform Franchise & Business Opportunities Act offers any meaningful protection to franchisees. It does not.

On the other hand, the Model Fair Franchise Law offers excellent protection to franchisees. It is patterned after the Wisconsin Fair Dealership Law which has been in effect for 15 years and based upon these 15 years of experience has been hailed as the franchisees; Magna Carta. That is why the franchisor lobby is so opposed to it.

I believe Mr. Fine's comments are self-explanatory. With the Chair's consent, I request that Mr. Fine's letter be made part of the hearing record.

I thank you for this opportunity to testify and I will be happy to respond to any questions you may have.

Thank you for your attention.

# # #

STATEMENT OF

NEIL A. SIMON

COUNSEL AND DIRECTOR OF

GOVERNMENT RELATIONS,

INTERNATIONAL FRANCHISE ASSOCIATION

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

SMALL BUSINESS SUBCOMMITTEE

ON ANTITRUST, IMPACT OF DEREGULATION

AND PRIVATIZATION

AUGUST 4, 1988

Introduction

Good morning, Chairman Eckart and members of the Small Business Subcommittee on Antitrust, Impact of Deregulation and Privatization. My name is Neil Simon. I am Counsel and Director of Government Relations to the International Franchise Association (IFA), a trade association representing more than 650 business format franchisors. IFA has served as the voice of the franchising community since 1960 and takes a special interest in laws and regulations affecting franchising. I welcome this opportunity to appear before you today.

Franchising in the Economy

Distribution of goods and services through franchising represents a vital segment of the American economy. According to the annual Department of Commerce survey entitled "Franchising in the Economy 1986-88", sales of goods and services in 1987 by franchising companies (product distribution franchisors and business format franchisors combined) reached an estimated $599 billion through more than 479,000 outlets which employed almost 7 million persons. More than one-third of all retail sales generated in the U.S. in 1987 were through some form of franchising. And while the United States economy grew by only 2.2% in 1986, sales by business format franchisors increased 10 percent and are expected to grow by 12 percent during the current year. Sales by business format franchisors in 1988 are expected to total some $190 billion.

Though there is no such thing as a guaranteed success in business, history has shown that the chance of success for a franchised business are

significantly better than for other independently-owned businesses. According to the U.S. Small Business Administration, nearly 38% of individual start-ups go out of business in the first year of operation. By contrast, less than 4 percent of franchised outlets are discontinued on an annual basis.

I understand that the Office of Management and Budget has disapproved further funding of "Franchising in the Economy," the source of these statistics. This comprehensive annual survey has been conducted for the past seventeen years and it is the only report of its kind, public or private, available about franchising. Because the gathering of this data requires businesses to divulge confidential information, the federal government is uniquely able to accomplish this task. Should this publication be abandoned, we will be without reliable data on an important sector of our economy. The International Franchise Association has urged the Administration to reconsider its disapproval and I would urge this committee to do the same.

Business Format Franchising vs. Product Distribution Franchising

State and federal authorities divide franchise relationships into two broad classes. The first class consists of produce distribution arrangements, often called "dealerships", in which manufacturers sell to dealers finished products, such as automobiles and gasoline, for re-sale. These dealers are only loosely identified with the product manufacturers' corporate identity. The second class consists of "business format" franchises which is characterized by a complete identification of the franchise with the franchisor and the licensing of a bundle of intellectual property rights revolving around the franchisor's trademark. In addition to adopting the franchisor's trade identity and image, these franchisees are required to conduct their businesses in accordance with prescribed and standardized procedures.

Dealership agreements are often unwritten and are generally of very short term -- far less than the 15 and 20 year terms typical of franchises. Unlike grantors of dealerships whose profits are derived solely from the sale of their products, franchisors' income is derived from franchise fees and royalties. Indeed, under federal and state antitrust law, it is generally considered an illegal "tie-in" for a franchisor to require its franchisees to purchase products from which the franchisor may derive profit. Inasmuch as royalties are based on the gross sales by the franchisee, the franchisor's profits are inextricably linked to its franchisee's health. It is also worth noting that the sale of dealerships is not regulated under the Federal Trade Commission's Franchise Rule.

The Franchise Agreement

The success of business format franchising lies in its careful balance of business interests: franchisees remain independent business owners afforded an opportunity to enter a proven business and enjoy the advantages of being part of a larger system; franchisors build the strength of their trademark and image through growth unavailable by conventional means of expansion and receive royalty income from their franchisees as the system grows.

This balance is struck in the contract signed by the franchisor and franchisee which sets forth their respective rights and obligations. Franchisees pay to the franchisor an initial franchise fee and monthly royalties. In turn, the franchisor established a fully integrated relationship with the franchisee governing the product or service, use of the franchisor's

trademark, site selection, marketing strategy and plan, advertising, operating standards and quality control. The franchisor provides a comprehensive operating manual and a system for regular communication with the franchisee for the duration of the agreement, typically 15 to 20 years.

The terms of these contracts vary from one franchisor to the next according to the design of their franchise systems. This adaptivity allows franchise systems to meet the demands of the marketplace and compete with large vertically-integrated chains. Members of the International Franchise Association range from Hilton Hotels to Midas Muffler, from Century 21 Real Estate to McDonald's, from H&R Block to Pearle Optical Centers, from Wendy's to Ziebart. And although these names may be familiar to you, the bulk of IFA's members are small businesses. Forty percent have fewer than 25 franchised outlets and an additional 25% have less than 100 units. Each system is unique.

Franchise Termination/Non-Renewal

The health of business format franchising is reflected in U.S. Department of Commerce data regarding termination, non-renewal and transfer activity. In the year 1986:

- Of the 12,999 franchise agreements up for renewal, 93 percent were renewed; of those not renewed, 79 percent were at the initiative of the franchisee or by mutual consent.
- Of the 244,501 franchisee-owned outlets, only 3% were terminated. A clear majority of those contracts terminated were at the initiative of the franchisee or by mutual consent.
- Ninety-eight percent of the franchisees who sought permission to sell their franchise (4,108 out of 4,202) were permitted to do so.

These statistics speak eloquently to the absence of abuse that might warrant additional government regulation of the franchise marketplace.

A franchisor generally invests considerable time, energy, and capital with the goal of establishing a reliable reputation for its product or service. Indeed, a franchisor's trademark usually acquires a "secondary meaning" in the public's mind and becomes a valuable asset in its own right. A franchisee whose performance is below the standards set out in the franchise agreement damages the trademark's secondary meaning. Such substandard performance reduces the value of the trademark to the franchisor and diminishes the business potential and reputation of the other franchisees. It also misleads members of the consuming public to believe that the substandard franchisee's products or services are of the same quality throughout the franchised system. Where a substandard franchisee is permitted to continue to use the franchisor's accumulated goodwill with the public, the consumer also suffers.

The primary method the franchisor has to protect the trademark, both for itself and for the benefit of the other franchisees, is to terminate its relationship with the substandard franchisee in accordance with the terms of the franchise agreement. Without the power to terminate in such situations, the franchisor's task of assuring reliability of product and services throughout its franchise system is jeopardized.

As logic dictates, so long as both parties considering a relationship are able to choose among alternatives, neither has the power to dominate the other. If, after full disclosure, a franchisor tells a prospective franchisee

to take it or leave it, there is a very good chance that the prospect will leave it and look elsewhere. Although the decision to purchase a franchise may be a prudent one, no one is required to do so and those that do make such a business decision should not be granted extra-contractural protection from risk. The decision to be a franchisee is a decision to bear business risk and be rewarded for it.

Nonetheless, as the figures discussed earlier indicate, franchise terminations occur extremely infrequently. A franchisor with cause to terminate generally provides the franchisee an opportunity to cure, not necessarily out of benevolence, but out of self-interest. In this regard, franchisors' power of termination is analogous to the power of repossession that may be employed by a secured creditor. Neither the franchisor nor the creditor typically gains if the threat is carried out, but the ability to carry out the threat carries with it substantial benefits. A franchisor who terminates an experienced franchisee would not only incur substantial costs but cut off the flow of royalty income from the franchise. Arbitrary and unfair terminations also impair the ability of the franchisor to build a franchise system. A franchisor has incentives to be fair if he wishes to retain its other franchisees and to attract new ones.

It is interesting to note that in its 1986 report on a proposed uniform franchise act, the American Bar Association Franchise Committee Task Force stated that:

> "it cannot be assumed that the bargaining power of franchisors in relation to franchisees is markedly tipped toward the franchisor in the broad range of industries in which franchising is used as a method of

distribution. In some industries or markets, or in some franchise systems, franchisees may have considerably more bargaining power or sophistication than in others. Even assuming that imbalances in bargaining power may result in one-sided contract terms, there has been no demonstrable evidence of abusive activities (such as arbitrary terminations or non-renewals or refusals to consent to transfers). [Indeed,] there are strong business incentives for franchisors not to engage in arbitrary or abusive behavior. They could incur substantial goodwill losses if they exploit the discretion afforded to them in their agreements, reducing the value of future franchises or dealerships and encouraging existing outlets to take steps to minimize potential losses in the event of similar treatment. (Emphasis added)"

Franchise Regulation

A variety of laws have been enacted that are specifically designed to regulate various aspects of franchising. At the federal level, the Federal Trade Commission issued its Trade Regulation Rule on Franchising and Business Opportunity Ventures, 16 CFR 436.1, on October 21, 1979. It requires disclosure of specified categories of information to a prospective franchisee at the earlier of the first personal meeting for the purpose of discussing the sale of a franchise or 10 business days prior to the execution of any franchise document or the payment of any consideration for the franchise.

The categories of information to be furnished in the disclosure document include, but are not limited to: the business experience and background of the franchisor and its directors and officers; a litigation and bankruptcy history of the franchisor and its directors and officers; a description of the franchise business; the initial and recurring fees to be paid to the franchisor by the franchisee; the revenue that may be received by the franchisor from various sources; purchase and sale restrictions imposed on the franchisee;

franchisor financing arrangements; termination and renewal terms; training programs; and financial information concerning the franchisor's financial condition for the three most recent fiscal years. In addition to the disclosure document, the franchisor also must furnish a copy of the proposed franchise agreement and any other agreements to be signed by the prospective franchisee. The FTC Rule deals only with full disclosure and does not regulate the terms of the franchise relationship.

In regard to enforcement, it should be noted that this past summer the Commission entered into a Consent Decree with Comprehensive Accounting Corporation, the nation's largest franchisor of bookkeeping, accounting, and tax services. The Decree settled charges that Comprehensive had violated Franchise Rule prohibitions regarding earnings claims. Potential redress to both current and former franchisees in this matter could reach $4 million. Commissioner Calvani has stated publicly that additional franchise cases are likely to be brought in the near future with special emphasis on instances of inadequate or inaccurate disclosures which may cause significant harm.

Prior to federal entry, some states enacted legislation governing franchise disclosure. California adopted the first franchise law, effective January 1, 1971. Following this, fourteen other states enacted laws requiring registration and/or disclosure of information prior to the sale of franchises. With the exception of Michigan and Oregon, all of these states require the franchisor to register with the appropriate state administrator prior to the offer and sale of franchises.

This committee should note that until 1984 Michigan, too, was a registration state. However, under the leadership of Governor James Blanchard, a task force was assembled to determine whether the burdens and expenses of

registration were justified in terms of their benefits. This task force, which included representatives of the state Attorney General's office, concluded that registration was unjustified and legislation was passed converting Michigan into a so-called "notice filing" state. The wisdom of this action was reflected in the FTC's 1985 Impact Study of the Franchise Rule which was unable to find any evidence that franchisees -- the protected class -- benefit from the prior approval process.

The growing state regulation of the sale of franchises, with diverse and sometimes conflicting requirements, led to the adoption of the Uniform Franchise Offering Circular (UFOC) Guidelines by the North American Securities Administrators Association (NASAA). The UFOC requirements were intended to introduce a degree of uniformity into the disclosure required before a franchisor may seek to sell franchises under state statutes and regulation. However, since each state may interpret the UFOC requirements differently, and some variation is imposed by statute, there remains a lamentable lack of uniformity. Although the UFOC ostensibly allows franchisors to use one document, 12 of the 14 registration states require approval of specific disclosure language and some states reject language mandated by other states. Indeed, as recently stated at an open meeting of the Federal Trade Commission, the substantial cost of complying with this complicated patchwork of state laws makes entry by new franchisors extremely difficult.

Effective January 1, 1989, franchisors using the UFOC format will be required by the Federal Trade Commission to comply with recent revisions to the UFOC format. To date, however, only Indiana, Illinois, Michigan, North Dakota, South Dakota and Wisconsin have adopted the new disclosure format. Other

states, including New York are not expected to adopt these changes. This will pose some extremely difficult questions for franchisors who are planning sales activity in states which fail to adopt the new format by putting them into conflict with the federal law. It may be that the FTC Rule's provisions on pre-emption will be put to the test.

In addition to franchise disclosure and registration law, another body of state franchise regulation also exists. In the early 1970's, legislation was adopted by many states dealing with specific aspects of the franchise relationship. All but one of the 16 state franchise relationship laws were enacted prior to promulgation of the FTC Rule in 1978. Although periodically advocated by advocates of incumbent franchisee rights, only two of these 16 states, New Jersey and Wisconsin, adopted a so-called "good cause" standard for franchise termination and non-renewal -- application of which has proven to discourage small business development. According to U.S. Department of Commerce data, while Michigan experienced a 22% increase in the number of franchises operating within its borders between 1982 and 1985, and Illinois a 28% increase, Wisconsin saw only 12% growth. This retarded rate of economic development can be attributed to the costly restrictions imposed upon franchisors under the Wisconsin law.

Rather than enacting restrictive legislation, states are now establishing programs to encourage franchising's growth within their borders. In Maryland, for example, IFA worked closely with the legislature and state officials to develop the nation's first program designed specifically to assist minority entrepreneurs interested in franchising. Other states, led by Michigan, are reconsidering in the entirety franchise laws passed prior to the enactment of the FTC Rule.

National Conference of Commissioners on Uniform State Law

The National Conference of Commissioners on Uniform State Laws (NCCUSL) decided in the summer of 1983 to undertake the drafting of a uniform act in the field of franchising. The drafting effort, spearheaded by Law Professor Jack Davies, former president of the Minnesota Senate, moved ahead with one drafting meeting in 1983, two in 1984, four in 1985, two in 1986, and one in 1987.

Successive drafts of the act were considered line-by-line at each of these two to three day meetings and by the Commissioners sitting in committee of the whole at annual meetings of the NCCUSL in August of 1985 and 1986. The Conference finally adopted the act at its annual meeting in August, 1987.

The committee intensively studied the relative merit of regulating the franchise relationship and worked strenuously to construct an act that balances the interests of franchisors and franchisees. According to the comment following Section 201 of the proposal:

> The Act relies on the duty of good faith rather than offering a code of prohibited or mandatory substantive actions or practices to govern the business relationship of parties to a franchise or business opportunity. More than two years of intense study and debate by the Drafting Committee, which considered several drafts that attempted to list prohibited and mandatory practices, led the NCCUSL to the conclusion that a list of prohibitions could not be expressed in a manner that was evenhanded, economically efficient, or responsive to the interests of consumers and of other franchisees or business opportunity operators. The NCCUSL also was concerned that the Act remain sufficiently flexible to be fair and appropriate over the enormous range of industrial sectors and geographic markets in which franchising is being employed and in which business opportunities may come to be employed as a legitimate production or distribution technique.

Many of us who have followed the NCCUSL drafting effort are skeptical that it will contribute toward the goal of uniformity. Indeed, although the American Bar Association House of Delegates endorsed the Act, it also recommended that a task force monitor its progress to ensure that it does not further complicate the existing regulatory pattern for franchisors. In addition, the ABA formed a new task force to examine "other means to uniformity," presumably including federal pre-emption.

The skepticism reflected in ABA's endorsement is well-founded. Few NCCUSL proposals are adopted in "as is" condition even when the field is clear of existing regulation. It is safe to predict that administrators in states with registration laws are likely to oppose the Act's filing provisions, and legislators in states with termination/non-renewal laws will be pressured not to dilute these provisions in favor of the Act's good faith requirement. I fear that the NCCUSL Act could become the theme around which new statutory variations are crafted -- just as occurred with the Uniform Franchise Offering Circular.

Conclusion

I appreciate the opportunity to have testified before you today and would be pleased to answer any questions.

REMARKS PREPARED FOR DELIVERY BY ANDREW KOSTECKA, FRANCHISE SPECIALIST, OFFICE OF SERVICE INDUSTRIES, INTERNATIONAL TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE BEFORE THE SUBCOMMITTEE ON ANTITRUST, IMPACT OF DEREGULATION AND PRIVATIZATION, AUGUST 4, 1988.

MY RESPONSIBILITY IN THE DEPARTMENT OF COMMERCE IS FRANCHISING AND ALL OF MY EFFORTS ARE SPENT IN THIS DIRECTION. FRANCHISING IS SIMPLY ONE ALTERNATIVE TECHNIQUE THAT A COMPANY HAS AVAILABLE IN ORDER TO DISTRIBUTE ITS GOODS OR SERVICES, BUT IT IS IMPORTANT TO REMEMBER THAT THIS MARKETING DEVICE INVOLVES LONG-TERM AND CONTINUING RELATIONSHIPS.

IT IS THE SERVICE OR MARKETING SECTOR OF OUR ECONOMY WHICH TODAY OFFERS THE GREATEST OPPORTUNITIES FOR NEW BUSINESS ENTRY AND GROWTH. ONE OF THE MOST CREATIVE OF THE VARIOUS MARKETING TECHNIQUES TO EMERGE IN THIS CENTURY IS THE SYSTEM OF FRANCHISING, GROWING RAPIDLY AND CONSTANTLY SETTING NEW RECORDS.

WE, IN AMERICA, SAY OUR ECONOMY IS BASED ON OUR SMALL BUSINESSES. WE RELY ON THEM AS JOB CREATORS, INNOVATORS, AND BY THEIR SHEER NUMBER, THEY PROVIDE A CERTAIN STABILITY IN OUR ECONOMY. FRANCHISING, BASICALLY, IS SMALL BUSINESS, AND FRANCHISING ENCOUNTERS A FRIENDLY CLIMATE IN THE UNITED STATES.

FRANCHISING IS PERHAPS THE ONLY FORM OF BUSINESS ORGANIZATION THAT, BY ITS VERY NATURE, TENDS TO CREATE NEW BUSINESS UNITS. WHEN THE FRANCHISEE JOINS THE FRANCHISE SYSTEM, HIS NEW TRADE NAME, THE ACQUISITION OF A DISTINCTIVE

BUSINESS APPEARANCE, AND THE STANDARDIZATION OF PRODUCTS, SERVICES, AND OPERATING PROCEDURES LEAD TO THE BIRTH OF A NEW ENTERPRISE FOR THE EXPRESS PURPOSE OF MARKETING THE FRANCHISOR'S PRODUCTS AND SERVICES.

FRANCHISING REPRESENTS THE SMALL ENTREPRENEURS BEST CHANCE TO COMPETE WITH GIANT COMPANIES THAT DOMINATE THE MARKETPLACE. WITHOUT FRANCHISING, THOUSANDS OF SMALL BUSINESSPERSONS WOULD NEVER HAVE HAD THE OPPORTUNITY OF OWNING THEIR OWN BUSINESS AND NEVER HAVE FELT THE IMMENSE SATISFACTION OF BEING A PART OF THE FREE ENTERPRISE SYSTEM.

ALL TRENDS INDICATE THAT FRANCHISING SHOULD CONTINUE TO EXPAND RAPIDLY, CREATING GREAT OPPORTUNITIES FOR EXISTING AND NEW BUSINESSES, CREATING NEW ENTREPRENEURS, NEW JOBS, NEW SERVICES AND PROVIDING NEW EXPORT OPPORTUNITIES FOR FIRMS ENGAGED IN FRANCHISING.

FRANCHISING, STILL IN A RELATIVE STATE OF INFANCY COMPARED TO THE LIFE SPAN OF OTHER MARKETING METHODS, HAS PLAYED AN IMPORTANT ROLE IN THE EVOLUTION OF THE SERVICE SECTOR OF THE AMERICAN ECONOMY. A CONFLUENCE OF FORCES, AMONG THEM THE DISTRIBUTION REQUIREMENTS OF MANY COMPANIES, AN INCREASED NUMBER OF INDIVIDUALS SEEKING THEIR OWN BUSINESS, AND CONSUMER SPENDING PATTERNS, CONTRIBUTED TO THE GROWTH OF FRANCHISING IN THE UNITED STATES AND HELPED IN PROMOTING IT IN MANY FOREIGN COUNTRIES.

TODAY, FRANCHISING IS A MAJOR FORCE IN THE U.S. ECONOMY AND ITS STEADY GROWTH IN SALES, UNITS AND EMPLOYMENT OFFERS TREMENDOUS OPPORTUNITIES TO INDIVIDUALS SEEKING THEIR OWN BUSINESSES AND COMPANIES LOOKING FOR WIDER DISTRIBUTION FOR THEIR PRODUCTS, SYSTEMS AND SERVICES. FRANCHISING HAS BECOME SO POWERFUL PARTLY BECAUSE ECONOMIC FACTORS HAVE MADE GROWTH THROUGH COMPANY-OWNED UNITS DIFFICULT FOR MANY BUSINESSES.

BUT THERE IS ANOTHER REASON FOR ITS GROWTH. FRANCHISING IN THE UNITED STATES IS NO LONGER THE EXCLUSIVE PROVINCE OF BIG BUSINESS. NOWADAYS, SMALL AND MEDIUM SIZE COMPANIES, EVEN THOSE WITH SMALL VOLUMES, OFTEN MAKE SUCCESSFUL FRANCHISORS.

FOR THE PAST SEVENTEEN YEARS, I PERSONALLY HAVE CONDUCTED A SURVEY FOR THE U.S. DEPARTMENT OF COMMERCE, COVERING THE FRANCHISE SYSTEM. OUR ANNUAL REPORT "FRANCHISING IN THE ECONOMY" IS THE ONLY SOURCE OF STATISTICAL DATA ON FRANCHISING, PUBLIC OR PRIVATE, COVERING BOTH TRADE NAME AND PRODUCT FRANCHISING AND BUSINESS FORMAT FRANCHISING.

IN THE UNITED STATES YOU CAN HARDLY BUY ANYTHING TODAY THAT DOES NOT GO THROUGH FRANCHISING IN SOME FASHION. NOT EVERYONE KNOWS WHAT FRANCHISING IS, BUT JUST ABOUT EVERYONE DOES BUSINESS WITH FIRMS IN THE SYSTEM.

MOST INDIVIDUALS HAVE THE DREAM OF OWNING ONE'S OWN BUSINESS BUT FEW WILL MAKE IT WITHOUT FRANCHISING--THE SYSTEM THAT PROVIDES THE KNOW-HOW, TRAINING, TRADENAMES, AND TRADEMARKS.

THERE IS NO SUCH THING AS A GUARANTEED SUCCESS IN FRANCHISING OR ANY OTHER TYPE OF BUSINESS. BUT IN FRANCHISING, HISTORY HAS SHOWN THAT YOUR CHANCES OF SUCCESS ARE SIGNIFICANTLY BETTER THAN IF YOU OPERATE A BUSINESS INDEPENDENTLY.

IN THE U.S., FRANCHISING IS PLAYING AN INCREASING ROLE IN THE ECONOMY: ITS GROWTH AND IMPACT CONTINUES TO BE PHENOMENAL. A GOOD YEAR IS EXPECTED IN 1988 AS SALES OF GOODS AND SERVICES BY ALL FRANCHISING COMPANIES SHOULD EXCEED $640 BILLION, THROUGH MORE THAN 509,000 OUTLETS AND PROVIDING EMPLOYMENT FOR ALMOST 7.3 MILLION PERSONS. IN 1988, 34 PERCENT OF ALL RETAIL SALES GENERATED IN THE U.S. WILL BE THROUGH FRANCHISING. TODAY THERE ARE OVER 2,600 BUSINESS FORMAT FRANCHISORS OPERATING IN THE UNITED STATES AND GROWING AT NET GAIN OF ABOUT 5 PERCENT ANNUALLY.

IN MY OPINION, THE MOST IMPORTANT PART OF THE ENTIRE FRANCHISING SYSTEM ARE THE FRANCHISEES, AS THEY ARE A FRANCHISING COMPANY'S MOST VALUABLE ASSET.

THE RELATIONSHIP BETWEEN FRANCHISOR AND FRANCHISEE IS THE KEY ELEMENT TO THE PRESENT AND FUTURE SUCCESS OF A FRANCHISOR, BECAUSE THEIR PERFORMANCE, BOTH AS INDIVIDUAL BUSINESSPERSONS, AND AS A PART OF A COORDINATED ORGANIZATION, DETERMINES WHETHER A FRANCHISING COMPANY WILL COMPETE, GROW AND BE PROFITABLE. A FRANCHISOR CAN DEVELOP SUPERIOR PROCEDURES AND PROGRAMS, BUT THEY ARE MEANINGLESS UNLESS FRANCHISEES PUT THEM INTO OPERATION IN THE MARKETPLACE.

SURPRISINGLY, MANY PEOPLE WHO ARE PART OF A FRANCHISING SYSTEM, FRANCHISORS AS WELL AS FRANCHISEES, DON'T REALIZE THAT A BUSINESS FRANCHISE ACTUALLY IS A COMBINATION OF THREE DIFFERENT RELATIONSHIPS:

IT IS A BUSINESS RELATIONSHIP.

IT IS A LEGAL RELATIONSHIP, AND.

IT IS A PERSONAL RELATIONSHIP.

IF THESE THREE RELATIONSHIPS ARE KEPT IN MIND AND SEPARATED, AND NOT CONFUSED WITH EACH OTHER, THE DISTINCTIONS WILL HELP KEEP THE OVERALL FRANCHISE RELATIONSHIP HEALTHY AND CONSTRUCTIVE.

IN EVERY SUCCESSFUL FRANCHISING ORGANIZATION--AND THIS IS WITHOUT EXCEPTION--NONE OF THE PARTIES HAVE UNLIMITED FREEDOM IN CONDUCTING THE BUSINESS. THE INTER-RELATIONSHIPS AND THE DEPENDENCIES DO NOT ALLOW TOTAL FREEDOM: THE FRANCHISOR IS DEPENDENT ON THE FRANCHISEES; THE FRANCHISE OWNER IS DEPENDENT ON THE FRANCHISOR; AND PERHAPS MOST IMPORTANT, FRANCHISE OWNERS ARE DEPENDENT ON EACH OTHER. THESE DEPENDENCIES IMPOSE RESPONSIBILITIES.

FRANCHISING CONTINUES TO PROVE, AS IF THAT WERE NEEDED, THAT IT IS A VALID MARKETING METHOD ADAPTABLE TO AN EVER-EXPANDING ARRAY OF INDUSTRIES AND PROFESSIONS. MARKET SHARES OF FRANCHISING ENTERPRISES ARE INCREASING, SOMETIMES SIMPLY BECAUSE NEW BUSINESSES ARE CREATED, BUT ALSO BECAUSE

SEGMENTS THAT PREVIOUSLY WERE CONTROLLED BY VERTICALLY-INTEGRATED OR INDEPENDENT FIRMS HAVE BEEN CAPTURED BY FRANCHISING.

EDUCATION WILL PLAY AN IMPORTANT ROLE IN THE DEVELOPMENT OF FRANCHISING AS PROGRAMS RELATED TO FRANCHISING ARE INCREASINGLY BEING TAUGHT IN CURRENT COURSES IN MARKETING, SMALL BUSINESS, AND ENTREPRENEURSHIP. IN THE COLLEGES AND UNIVERSITIES OF THE WORLD, THE STUDY OF FRANCHISING IS BECOMING RECOGNIZED AS A NEW AND IMPORTANT PART OF BUSINESS STUDIES.

IN THE ECONOMY AS A WHOLE, MAJOR CHANGES ARE IN PROGRESS. AS WE MOVE INTO THE 21ST CENTURY, CREATIVITY AND IMAGINATION IN THE DEVELOPMENT OF NEW GOODS AND SERVICES WILL BE RICHLY REWARDED. EDUCATION, COMPUTER USAGE, AND THE ABILITY TO WORK WITH AND MANAGE PEOPLE WILL BE PROFITABLY UTILIZED BY NEW EMERGING BUSINESSES. ALL THESE TRENDS SUGGEST THAT FRANCHISING WILL BE THE LEADING METHOD OF DOING BUSINESS IN THE 21ST CENTURY.

TESTIMONY OF BYRON E. FOX

My name is Byron Fox. I have practised law in New York for over 30 years. My fields of practice encompass franchising and distribution, antitrust and securities regulation. I have had the opportunity over the years to observe the growth of franchising as a vehicle for the distribution of goods and services and I have dealt frequently with the legal and regulatory issues involved in the franchising process.

I have been asked to testify from the franchisor's point of view and I do so willingly since I view the practices of today's franchisors as efficient and beneficial to consumers. Nevertheless, I fully recognize the contributions of thousands of franchisees whose efforts, in conjunction with their franchisors, have made franchising the fastest-growing segment of our economy.

During the past dozen years, I have also had the opportunity to lecture and write about franchising issues. I teach franchising at Fordham Law School in New York, at which I am an Adjunct Professor and at the Law School of the University of Virginia, at which I am a Lecturer in Law. I have also written many articles on franchise law.

I must add for the record that I serve on the Governing Committee of the American Bar Association's Forum Committee on Franchising and that I have participated in the deliberations of the National Conference of Commissioners on Uniform State Laws,

which led to the preparation of a uniform franchise law. That proposed law will soon be sent to the legislatures of all of the states for their consideration. Also, lest I be accused of non-disclosure, I must tell you that I serve as a member of the [illegible] Committee of the International Franchise Association, a trade association comprised of franchisors.

The Committee should note that I do not testify on behalf of the ABA or the National Conference of Commissioners on Uniform State Laws. I have no such authority. Nor, for that matter, do I testify on behalf of any industry or trade group. I am here at my own expense carrying no client's brief. My purpose in being here is solely to provide the Committee with a responsible overview of franchise regulation as it stands today.

My starting point is that franchising works! Despite an over-abundance of legislative and regulatory obstacles, many of which are damaging to franchisors and franchisees alike, franchising accounts for over 40 cents of every retail dollar spent in America today. That success was not attained by franchisors oppressing franchisees or denying franchisees the benefit of their labors. That success should indicate as well that any further legislative or regulatory initiatives should be the product of thoughtful analysis rather than an emotional response to the perceived grievances of unsuccessful franchisees.

I am sure that there will be witnesses at these hearings who will parade before you examples of victimization of franchisees

and who will tell carefully-crafted tales of woe. I am equally certain that those who have a political axe-to-grind will not parade before you thousands of franchisee success stories that have been far more typical. Frankly, I find it hard to imagine a better vehicle to foster the growth of small business than franchising and I want to dwell on that for a moment.

When we speak of "small business" in the context of franchising, it is too easy to equate the term with the "franchisee". What is almost universally misunderstood is that an overwhelming number of franchisors are small businessmen and businesswomen. For every McDonald's chain, there are thousands of small businesses seeking to expand by allowing franchisees to copy what they have developed through their own energy, foresight, and investment. The perceived imbalance of economic power between franchisors and franchisees is something of a myth. At the very least, it is a woefully inadequate linchpin for analyzing the relationship between franchisors and franchisees since some franchisors possess economic power, but most do not.

In assessing the merit or lack of merit of franchise regulation, we should keep in mind the current regulatory pattern. The FTC's Rule applies across the nation. The Rule requires full disclosure so that a prospective franchisee has the opportunity to know what he or she is being asked to buy. The Rule further contemplates that the states that choose to do so may enact tougher, but not weaker, laws regulating

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franchising. Fifteen states have adopted registration or disclosure laws of their own. These laws are enforced by state administrators, whose performance, overall, has been reasonably satisfactory. Thus, we have not one but two systems of franchise regulation.

Further, in evaluating the merit of franchise disclosure regulation, which came into existence to redress fraudulent abuses in the '50's and '60's, it is fair to say that such disclosure has done its intended job. Charlatans and "con artists" find little comfort in promoting phoney franchise schemes. The "Music Man" could not sell his uniforms and instruments today without full disclosure.

Although blatant fraud has been virtually eliminated from franchising by registration and disclosure laws, the proliferation of regulation has had a price. The comprehensive disclosure requirements of the Federal Trade Commission Rule on franchising and the state franchise registration, disclosure and business opportunity laws have made franchising the most highly regulated industry segment in this country, save for the securities industry.

The impact of the two-tiered (federal and state) regulatory framework upon franchisors can be destructive. Start-up franchisors are often precluded from expanding on a national or regional basis due to their inability to satisfy divergent registration requirements or to pay the added legal, accounting and compliance costs of a national franchise registration

program. Even established franchisors are faced with a mine-field of conflicting statutes and regulations requiring extensive supervision of disclosure and sales activities, and the management of upwards of eighteen different disclosure documents.

Moreover, the current franchise regulatory framework makes small mistakes prohibitively expensive. Technical non-compliance with the franchise registration laws, although sometimes trivial to the layman is a serious problem for the franchisor. Inadvertent and honest mistakes, usually the result of misguided advice, can fatally taint an otherwise sound franchise program.

A franchisor with over one hundred franchisees recently sought our advice. The legal and accounting advice the company had previously received was flawed. Its franchise disclosure documents were technically deficient. Its franchise registrations had lapsed in a number of states. Interestingly, over the years, there had not been a single complaint by any franchisee. Despite the franchisor's non-compliance, virtually all of the franchisees were quite profitable. Our investigation revealed that despite the ineffective guidance the franchisor had received with respect to franchise compliance, the company had given its franchisees quality service and had lived up to its commitments under its franchise agreements. Nevertheless, this franchisor faced the prospect of refunding hundreds of thousands of dollars to its franchisees pursuant to rescission

offers that were swiggered by harmless and trivial errors.

The inconsistent and often duplicative registration and disclosure system also impacts dramatically upon the franchisor's ability to do business. Registration and/or disclosure laws which differ markedly from each other have been enacted in fifteen states (California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin). Additionally, franchisors may need to comply with a variety of business opportunity laws which have been enacted in twenty-three states. The high cost of compliance has been documented by the FTC's Report on the impact of the FTC Trade Regulation Rule. Further, the statutes have varying definitions and disclosure requirements, conflicting extraterritoriality provisions, and divergent capitalization requirements.

Let me provide some examples. Most franchise registration states require that a franchisor have a minimum level of capitalization. While the states uniformly review a franchisor's financial statements with a view to determining whether it can satisfy its obligations to its franchisees, the actual capitalization requirements are inconsistent. Some states may require a franchisor to place franchise fees in escrow pending satisfaction of pre-opening obligations, others have no such provisions. Some states may require the filing of a surety bond, (which in many circumstances is prohibitively expensive), others do not. A franchisor's net worth may be

sufficient to satisfy a regulation in one state, but not in another. Finally, the levels of sophistication of the franchise examiners in the various states are far from uniform. There is a divergent understanding and analysis of the financial arrangements of many franchisors, and yet frankly, those arrangements are usually not very complicated.

A franchisor that can afford to pursue a national registration of its franchise program may, nevertheless face inconsistent standards of review. Provisions questioned in one state will pass without comment in others. The scope of comments issued by a state franchise administrator's office often is dependent upon which individual examiner has responsibility for a given file. Furthermore, limited budgets preclude the hiring of enough qualified personnel to review submissions.

Even large franchisors, that is, franchisors with net worths in excess of five million ($5,000,000) are faced with divergent exemptions from the various states' registration and disclosure statutes. Thus, while the States of California, New York, [illegible] Washington and Maryland have varying exemption provisions based upon net worth, there are no such provisions in Hawaii, Illinois, Minnesota, South Dakota and Virginia. Perhaps the most glaring inconsistency is that a franchisor is barred from negotiating the terms of a franchise agreement in some states but is required to do so in others.

The experience of the State of Michigan illustrates what can

happen when regulatory burdens are eased. Michigan had one of the most stringent and rigid franchise registration statutes in the country. The State was generally rated by franchisors as one of the worst states in which to do business. Rather than comply with the Michigan law, franchisors simply chose not to do business there. In 1984, the Michigan Act was converted to a pure disclosure law similar to the Federal Trade Commission Rule. The need for a franchisor to register its offering documents was eliminated. In 1980, 17 franchise companies registered to do business in Michigan. During the twelve months immediately following the enactment of the less onerous Michigan [illegible] 148 companies moved into Michigan. The following twelve months brought another 275 franchisors and from June, 1986 through March, 1987 more than 500 additional companies registered to franchise in Michigan.

Given these inconsistencies, of which I have cited only a few, it would be salutary for franchisors and franchisees alike to have a uniform standard of disclosure. My service to the committee of the National Conference of Commissioners on Uniform State Laws that prepared the Uniform Franchise and Business Opportunity Act has led me to the conclusion that uniformity can be achieved.

My fear, however, is that when the state legislatures consider adopting the Uniform Act, or even after having adopted the Act, they will be tempted to "tinker" with it. If they do, we will be right back at the starting point, with no uniformity

and even more confusion than we have today.

One way to prevent that outcome would be for this Committee to advance legislation adopting the Uniform Act as the national standard for franchise disclosure. I would, however, hope you [illegible] the task of enforcing the criminal aspects of the Uniform Law.

There is one other aspect of franchise regulation that is worthy of comment. Some franchisee groups and their representatives perceive that there are profound abuses in franchise terminations and non-renewals. They maintain that franchisees are treated poorly in those areas.

The Department of Commerce's statistical survey of terminations, non-renewals and transfers for the year 1985 demonstrates that abusive conduct in these areas is, if anything, quite marginal. In 1985, 12,543 franchise agreements came up for renewal. Ninety-one percent were renewed. Also in that year, 7,450 franchise agreements were terminated. Approximately 2,600 were terminated by franchisors, mainly for nonpayment of fees; 4,300 by franchisees and an additional 450 by mutual consent. 96.5% of all proposed franchise transfers were approved by franchisors in that same year. These figures do not support the existence of gross abuse.

Despite the absence of any pressing need for legislation to make terminations or non-renewals more difficult for franchisors, advocates of increased regulation promote their pro-franchisee agenda by distorting traditional legal

conceptions such as the doctrine of "good faith and fair dealing" and "good cause" for termination. They even claim that the franchisor-franchisee relationship is one in which the franchisor owes the franchisee imaginary "fiduciary" duties.

As I said earlier, the supposed disparity in bargaining power between franchisors and franchisees is mythical. Any given prospective franchisee has the choice of purchasing any one of hundreds of franchises. More importantly, any prospective franchisee can go into business for himself or herself. Hence, it is inappropriate to claim that the supposed disparity in bargaining power between franchisors and franchisees justifies granting to franchisees special advantages beyond their contractual rights. A prospect is free to walk away.

It is important to understand that most small businesses fail. They fail in substantial numbers. On the other hand, franchisees very largely do not fail. They succeed because much of their work has been done for them -- they invest in a proven system and they purchase a license to prosper under trademarks and names others have developed, often at enormous expense to themselves. There is obviously a trade-off for the security of purchasing a license to operate a franchise instead of entering one's own business. The buyer is not free to act outside the terms of the license, the buyer must conform to the system and, most important of all, the buyer does not have the right to a perpetual free ride.

No amount of shading of the meaning of established legal concepts can twist the franchisor-franchisee relationship into something it is not. Further, franchisors have very little incentive to terminate or not renew successful franchisees. They benefit from successful franchises and to end the life of such a franchise would be wholly irrational.

In all, I am much more concerned about inconsistent and burdensome disclosure requirements than about the threat of economically irrational conduct by franchisors. It is my hope that this Committee, on study of the issues, will agree with me. Thank you for the opportunity to testify.

UNIFORM FRANCHISE AND BUSINESS OPPORTUNITIES ACT

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS NINETY-SIXTH YEAR
IN NEWPORT BEACH, CALIFORNIA
JULY 31 - AUGUST 7, 1987

With Prefatory Note and Comments

UNIFORM FRANCHISE AND BUSINESS OPPORTUNITIES ACT

The Committee that acted for the National Conference of Commissioners on Uniform State Laws in preparing the Uniform Franchise and Business Opportunities Act was as follows:

JACK DAVIES, William Mitchell College of Law, 875 Summit Avenue, St. Paul, MN 55105, Chairman
JAMES C. McKAY, JR., Office of the Corporation Counsel, Room 343, 1350 Pennsylvania Avenue, N.W., Washington, DC 20004, Drafting Liaison
LIONEL H. FRANKEL, The University of Utah, College of Law, Salt Lake City, UT 84112
STEPHEN G. JOHNAKIN, P.O. Box 14515, Richmond, VA 23221
BENNY L. KASS, Suite 1100, 1050 Seventeenth Street, N.W., Washington, DC 20036
JOHN L. McCLAUGHERTY, P.O. Box 553, Charleston, WV 25322
DONALD E. MIELKE, Suite 300, 1726 Cole Boulevard, Golden, CO 80401
HOWARD T. ROSEN, 23rd Floor, 80 Park Plaza, Newark, NJ 07102
ANDREW C. SELDEN, 2400 IDS Center, Minneapolis, MN 55402, Reporter
PHILLIP CARROLL, 120 East Fourth Street, Little Rock, AR 72201, President (Member Ex Officio)
WILLIAM J. PIERCE, University of Michigan Law School, Ann Arbor, MI 48109, Executive Director
WINDSOR DEAN CALKINS, 1163 Olive Street, Eugene, OR 97401, Chairman, Division G (Member Ex Officio)

Review Committee

WILLIAM C. HILLMAN, 403 South Main Street, Providence, RI 02903, Chairman
PETER J. DYKMAN, Room 217 North, State Capitol Building, Madison, WI 53702
FREDERICK P. O'CONNELL, 74 Winthrop Street, P.O. Box R, Augusta, ME 04330

Advisors to Special Committee on
Uniform Franchise and Business Opportunities Act

RUPERT M. BARKOFF, American Bar Association
ANDREW CAFFEY, International Franchise Association
TIMOTHY FINE, National Alliance of Franchisees
ALAN E. KORPADY, North American Securities Administrators Association, Inc.

Final, approved copies of this Act and copies of all Uniform and Model Acts and other printed matter issued by the Conference may be obtained from:

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS
645 North Michigan Avenue, Suite 510
Chicago, Illinois 60611
(312) 321-9710

UNIFORM FRANCHISE AND BUSINESS OPPORTUNITIES ACT

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UNIFORM FRANCHISE AND BUSINESS OPPORTUNITIES ACT

PREFATORY NOTE

Procedural History

The National Conference of Commissioners on Uniform State Laws (NCCUSL) decided in the summer of 1983 to undertake the drafting of a Uniform Act in the field of franchising. The decision to make this Act part of the Conference program followed a year of work by a study committee that explored the need for and feasibility of such an Act.

The drafting effort moved ahead with one drafting meeting in 1983, two in 1984, four in 1985, two in 1986, and two in 1987. Successive drafts of the Act were considered line-by-line at each of these meetings. Drafts were also considered line-by-line by the Commissioners sitting in Committee on the Whole at Annual Meetings of the NCCUSL in August of 1985 and 1986. The Conference promulgated the Act at its annual meeting in August, 1987 after a third line-by-line reading.

The Need for a Uniform Act

The NCCUSL starts each drafting project expecting to produce an Act that will be useful to its legislator constituents. Four elements especially seem to point toward a successful NCCUSL project. First, the Conference has had its greatest success in commercial law. Second, the Conference has done well with Acts that set rules governing long-term business relationships. A third factor identifying the most successful NCCUSL undertakings is complexity, for when a project is complex, legislatures welcome the help offered by the NCCUSL, a group that is willing to study a thorny subject in great detail over several years.

Finally, the Conference does best when the need for uniformity of law among the states is manifest. Legislators understand the legal hazards that arise whenever business affairs flow across state lines while the law does not. Legislators then see the value of enacting a uniform act that minimizes the aggravation of shifting legal rules.

Applying these four criteria to the law of franchising and business opportunities, we find that on this topic the Conference has addressed legal rules that: affect commercial life, regulate long-term

relationships, involve complex policy judgments, and cover activities that, although interstate, are now controlled by state laws of great variety. Promulgating a Uniform Act on franchises and business opportunities, therefore, is an undertaking within the profile of NCCUSL success.

Franchising plays a major role in the distribution of goods and services in the American economy. Many franchisors operate nationally and franchisees may do business in more than one state. Legislative consideration of bills affecting the field of franchising has been continuous for a decade and a half. Twelve states regulate franchise offerings with registration laws enacted in the early 1970s (New York's law was enacted in 1980). The Federal Trade Commission promulgated a Trade Regulation Rule on Franchising and Business Opportunities in 1979. Twenty-three states regulate "business opportunities" to some degree. Legislative activity continues to the present time, as illustrated by the bills introduced in legislatures around the nation during 1985 and 1986.

During those two years, bills on dealer relationships in the field of distribution, usually including franchise relationships, were introduced (but not enacted) in Alaska, Arizona, California, Connecticut, Iowa, Massachusetts, Minnesota, Missouri, Nebraska, Nevada, New York, Rhode Island, and Tennessee. Legislation (minor corrective amendments to an older statute) was enacted in Connecticut. In 1984, Michigan repealed its franchise registration statute in favor of a simple disclosure and anti-fraud requirement.

Bills amending franchise sales practices laws were introduced in California, Illinois, Indiana, and Minnesota.

Bills on business opportunities were introduced in Indiana, Maine, New York, Ohio, Oklahoma, South Dakota, South Carolina, and Texas. Amendments to older statutes were enacted in Indiana, Maine, and South Carolina.

Legislative activity in these areas may be expected to continue.

The Draft

The NCCUSL Drafting Committee worked to construct an act that balances the interests of franchisors, franchisees, and the public - an act that provides

sensible law for franchising arrangements. Too many state laws now in effect have arisen out of political power struggles; the statutes in many cases represent a legislative victory for one side or the other based on political strength, rather than being the considered outcome of an effort to produce efficient, fair, and balanced law. Current law, in many instances, misses a fair balance between the interests of franchisor and franchisee and often ignores altogether the interests of consumers, other franchisees in the particular franchise system, or prospective franchisees in that system.

The Uniform Franchise and Business Opportunities Act contains five Articles. The first Article includes definitions and other general provisions. The second Article codifies certain minimum standards of conduct in franchise and business opportunity relationships. The third Article covers franchise sales practices. The fourth Article covers business opportunities sold on the strength of representations of near certain profitability. The business opportunities Article is subject to extensive exceptions, however, including an exception for businesses that meet the franchise criteria. The fifth Article includes the administrative provisions of the Act, as well as sanctions for violations of its provisions. Discussion of the main substantive themes of Articles II, III, IV, and V follow.

Article II

Article II imposes a general duty of good faith on parties to a franchise or business opportunity relationship. The duty is derived from the common law, Section 205 of the Restatement (Second) of Contracts, and the Uniform Commercial Code. Article II generally reflects current case law. It makes no unwarranted economic or political assumptions. It prevents surprise and, in combination with Sections 105 and 106, enhances the likelihood that the justified expectations of parties to a franchise or business opportunity will be fulfilled.

Article III

Article III governs offers and sales of franchises. It requires the franchisor to disclose material information so that a person who is considering the purchase of a franchise may make an informed investment decision. The Act provides a private right of action and strong public agency enforcement power to encourage compliance in lieu of

the regulatory regime under the 12 state laws that now regulate franchise sales through a presale registration process.

Franchise law currently in place varies from a self-implementing disclosure requirement under a 1979 Federal Trade Commission Rule, to similar disclosure requirements under state law in Oregon and Michigan, to full presale registration requirements in 12 states (California, Illinois, Indiana, Maryland, Minnesota, North Dakota, New York, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin). All but the New York statute were enacted in the early 1970's. Hawaii has a filing and disclosure requirement. Michigan repealed its registration law in 1984 but retained presale disclosure and anti-fraud requirements. The remaining 35 states have no franchise registration or disclosure law of general applicability. The registration process in the 12 states constitutes a review of the disclosure document and in some states includes a screen for forbidden contract terms. Unlike state securities regulation, states currently do not conduct "merit" evaluation of proposed franchise offerings.

Varying regulatory attitudes in the registration states combined with varying state policies on such subjects as choice of law and choice of forum clauses, post-termination covenants not to compete, flexible franchise fee structures, etc., result in an inability of multistate franchisors to administer uniform franchise offerings across some state lines. "Red tape" in one or two states adds needless delay and expense to franchise offerings. This Act does away with the regulatory burden of registration in the maturing area of franchising, while preserving the process in the much newer area of "business opportunities."

Article IV

Article IV, the business opportunity article, should have a salutary effect in controlling the purveyors of various get-rich-quick schemes. It is designed to have relatively little impact on mainstream commercial enterprises.

Article IV relies for its effectiveness primarily on a requirement of presale registration by the promoter/seller of a business opportunity. Experience has demonstrated that shady operators do not in fact register, but nonregistration provides the means by which the enforcement authorities can force fraudulent

promoters out of the market immediately upon discovery. That is, nonregistration provides a basis for a cease and desist order and there is then no need actually to show the fraudulent nature of the particular business opportunity.

The second control device is a requirement that the promoter maintain a bond, escrow deposit, or letter of credit to back up any promise to buy-back goods or to guarantee profit. The promoter can avoid this requirement by refraining from making the kind of representation that is the hallmark of offensive practices in the sale of business opportunities.

Article V

Remedies and administrative provisions are collected in Article V. The rationale for reducing the regulatory barrier to entry to the use of franchising as a method of distribution is the ready availability of effective private and public recourse against transgressions. Article V provides a clear and straightforward civil right of action and powerful public investigatory and enforcement power. The remedial provisions should provide both substantial deterrence against business opportunities abuses and modest hope for recovery from violators, but without establishing insurmountable barriers for legitimate users of distribution techniques that may also fall under the definition of "business opportunities." The private right of action makes up for the most glaring shortcoming of the FTC Trade Regulation Rule, the long-recognized absence of a private cause of action for violation of the Federal Trade Commission Act or rules promulgated thereunder.

The illogic and impracticality of operating national distribution systems under widely varying state laws should be obvious. The Conference believes that this Act represents a middle ground of thoughtful accommodation to competing interests. It is a forward step for the law.

Advisors

The Committee had assistance from a number of advisors throughout its work.

Official liaisons to the Committee from the American Bar Association were Martin Fern, Los Angeles, and Rupert Barkoff, Atlanta.

In addition, Byron E. Fox of New York served as liaison from the ABA Forum Committee on Franchising.

Andrew A. Caffey of Washington was official advisor to the committee from the International Franchise Association, a trade association representing franchisors.

Timothy Fine of San Francisco was the official advisor to the committee on behalf of the National Association of Franchisees and Dealers.

Alan Korpady of Wisconsin was the official advisor to the committee on behalf of the North American Securities Administrators Association, Inc., the securities commissioners and other officials who regulate franchising and business opportunities in the various states. Early in the project Cheryl Friedman of Iowa served in that advisory role.

In addition to these official advisors, the committee had the assistance of numerous observers who participated in advising the committee. Particularly active were:

John Baer, John Brown, Brian Butler, Ray Edwards, Michael Eisenberg, Myron Gordon, Robert Joseph, Simon Lazarus, H. Bret Lowell, Michael Lundsford, Quinn Martin, Lewis Rudnick, George Rummel, Neil Simon, and Richard Superfine.

UNIFORM FRANCHISE AND BUSINESS OPPORTUNITIES ACT

COMMENT

Although divided into separate Articles for ease of reference and understanding, no part of the Act is intended for separate enactment.

ARTICLE I

GENERAL PROVISIONS

SECTION 101. DEFINITIONS.

As used in this [Act]:

(1) "[Administrator]" means the [title of enforcement official].

(2) "Advertisement" means information published in connection with an offer or sale of a franchise or business opportunity.

(3) "Affiliate" means a person controlling, controlled by, or under common control with another person.

(4) "Business day" means a day other than a Saturday, Sunday, or legal holiday under the laws of this State.

(5) "Business opportunity:"

(i) means a plan, agreement, or transaction, oral or written, between two or more persons, under which:

(A) a purchaser pays or agrees to pay an initial payment of $500 or more;

(B) a promoter or its affiliate or designee disposes, or offers or attempts to dispose, of goods or services to the purchaser, whether or not for resale, to assist the purchaser to begin a business; and

(C) the promoter or its affiliate or designee represents that:

(I) the promoter or its affiliate or designee will refund all or a substantial part of the purchaser's initial payment if the purchaser is unsuccessful or dissatisfied with the business opportunity;

(II) the promoter or its affiliate or designee will reimburse the purchaser for, or will purchase from the purchaser, goods the purchaser produces, grows, or modifies, or services the purchaser performs, using goods or services supplied by the promoter or its affiliate or designee, or resulting from those goods or services;

(III) the purchaser's success with the business opportunity is ensured because the promoter or its affiliate will provide, or will assist the purchaser in finding, locations or accounts for the use, operation, or placement of vending machines, racks, display cases, or similar devices, on premises the purchaser does not own or lease;

(IV) the purchaser's success with the business opportunity is ensured by a marketing plan prescribed in substantial part by the promoter or its affiliate under which the promoter or its affiliate will provide to the purchaser training, or marketing assistance, in the purchaser's method of operation; or

(V) the business opportunity is free from risk or certain to produce profits, which representation may arise from all of the assurances taken as a whole; but

(ii) the term does not include:

(A) a franchise;

(B) a security or a transaction in a security that is registered or qualified under or otherwise complies with [state securities act];

(C) a plan by a retailer of goods or services for the operation of a leased department within premises controlled by the retailer;

(D) a bona fide liquidation of a business; or

(E) a disposition of an interest in real property.

(6) "Designee" means a person whom a promoter designates as a source of goods or services to be used by a purchaser of a business opportunity and who gives consideration to the promoter or its affiliate in

connection with either the designation or the disposition of goods or services to the purchaser.

(7) "Franchise" means:

(i) an agreement, express or implied, oral or written, between two or more persons by which:

(A) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan prescribed in substantial part by the franchisor;

(B) operation of the franchisee's business pursuant to the marketing plan is substantially associated with a trademark, service mark, trade name, advertising, or other commercial symbol designating, owned by, or licensed by the franchisor or its affiliate; and

(C) the franchisee pays, agrees to pay, or is required to pay, directly or indirectly, a franchise fee; or

(ii) a master franchise.

(8) "Franchise fee" means a fee or charge for the right to enter into or maintain a business under a franchise, including a payment or deposit for goods, services, rights, or training, but not including:

(i) payment for a reasonable quantity of inventory goods at a bona fide wholesale price;

(ii) payment at fair market value for purchase or lease of real property, fixtures, equipment, or

supplies necessary to enter into or to maintain a business;

(iii) payment for goods on consignment, if the proceeds remitted by the consignee from sale of the goods constitute only the bona fide wholesale price of the goods;

(iv) payment of a reasonable service charge or discount to the issuer of a credit card by a person honoring the credit card or to a trading stamp company by a person issuing trading stamps;

(v) payment of a commission or compensation in a transaction constituting in substance only a bona fide wholesale transaction;

(vi) repayment of a bona fide loan;

(vii) payment of a bona fide security deposit for real or personal property; or

(viii) payment of a bona fide rental or cooperative advertising charge by a tenant in a shopping center to the shopping center or to a person designated by the operator of the shopping center.

(9) "Franchisee" means a person to whom a franchise is granted.

(10) "Franchisor" means a person who grants a franchise and includes a subfranchisor with respect to a franchise the subfranchisor offers or sells.

(11) "Initial payment" means an amount the purchaser of a business opportunity pays or is

obligated to pay to the promoter or its affiliate or designee before the end of the sixth month after the date of the business opportunity agreement, but does not include:

(i) payment for a reasonable quantity of inventory goods at a bona fide wholesale price;

(ii) payment of a bona fide security deposit in connection with the bailment of goods for demonstration, sample, or similar purposes, in an amount not in excess of the greater of the fair market value or reasonably anticipated replacement cost of the goods; or

(iii) payment of a bona fide rental or cooperative advertising charge by a tenant in a shopping center to the shopping center or to a person designated by the operator of the shopping center.

(12) "Master franchise" means an agreement in which a franchisor, for consideration given for the right, grants a subfranchisor a right to offer or sell franchises for the subfranchisor's account. A franchise is not a master franchise solely because the franchise grants a person a right to receive compensation for making referrals to a franchisor or subfranchisor. A relationship between a franchisor and a broker, agent, or sales representative who does not have an ongoing relationship with franchisees of the franchisor is not a master franchise unless the broker,

agent, or sales representative gives consideration to the franchisor or its affiliate in exchange for a right to offer franchises.

(13) "Offer" or "offer to sell" means an offer, or an attempt to offer, to dispose of, or a solicitation of an offer to obtain, an interest in a franchise or business opportunity, but does not include (i) renegotiation or other conduct in anticipation of renewal, replacement, or extension of an existing franchise or business opportunity, whether or not the existing agreement is to be modified or replaced, or (ii) an offer to acquire an interest in a franchise or business opportunity.

(14) "Order" means an action of the [Administrator] applicable to a particular matter.

(15) "Person" means an individual, corporation, business trust, estate, trust, partnership, joint venture, association, government, governmental subdivision or agency, any other legal or commercial entity, or the [Administrator].

(16) "Promoter" means a person who offers or sells a business opportunity or an agent of that person.

(17) "Publish" means to disseminate information to the public or to a segment of the public.

(18) "Rule" means a regulation or standard of general application promulgated by the [Administrator] under this [Act].

(19) "Sell" means to dispose, or to agree to dispose, of an interest in a franchise or business opportunity, but does not include renegotiation or other conduct in anticipation of renewal, replacement, or extension of an existing franchise or business opportunity, whether or not the existing agreement is to be modified or replaced.

(20) "State" means a state, territory, or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico.

(21) "Subfranchisor" means a person who acquires a master franchise.

COMMENT

1. Paragraph (1): The designation of the official who is to be the Administrator of this Act is discretionary with the enacting state. The Administrator should be an official with law enforcement authority, such as an attorney general or commissioner of commerce. States are strongly encouraged, however, to employ the uniform designation of "Administrator" to enhance uniformity of usage and facilitate understanding of and compliance with this Act in enacting states.

2. Paragraph (5): The definition of a "business opportunity", and the scope of coverage and substantive requirements of Article IV, differ materially in certain respects from the corresponding provisions of the FTC Rule (16 CFR Part 436). Under the FTC Rule, state law may afford equal or greater protection than the Rule to prospective purchasers of business opportunities but compliance with the FTC Rule may not be excused where the state law does not provide the

same degree of protection. The definition is also subject to certain exemptions (Section 401).

3. Paragraph (5)(i)(C): A mere warranty of the quality or performance of goods or services, or other customary warranties, expressed or implied, do not come within subparagraph (5)(i)(C). A refund provision described in subparagraph (5)(i)(C)(I) is, rather, an assurance that the buyer faces no risk with the business opportunity venture.

4. Subparagraph 7(i)(B) is not satisfied merely because a person sells a branded product or service.

5. Subparagraphs (8)(viii) and (11)(iii) reject the conclusion in Fisherman's Net, Inc. v. Weiner, 608 F. Supp. 1283 (D. Me. 1985) (bona fide shopping center rental or cooperative advertising charges can constitute an "initial payment" or its equivalent under Maine business opportunity law).

6. Paragraph (12): The phrase "for the subfranchisor's account" implies that the subfranchisor retains some residual equity interest in the resulting subfranchise relationship. The phrase excludes from the definition an agreement that in substance is an agreement merely to be a commissioned sales representative.

7. Paragraph (21): A subfranchisor is a "franchisor" (paragraph (10)) in respect to a franchise it offers or sells.

SECTION 102. TERRITORIAL APPLICABILITY.

(a) This [Act] applies to a franchise or business opportunity that is offered or sold in this State after the effective date of this [Act]. Article II of this [Act] also applies to a franchise or business opportunity that is operated in this State by the franchisee or purchaser if it is renewed by agreement of the parties to the relationship after the effective date of this [Act].

(b) A franchise or business opportunity is offered or sold in this State if an offer to sell is made or accepted in this State or an offer to buy is accepted in this State.

(c) An offer to sell is made in this State if the offer is directed by the offeror into this State from within or from outside this State and is received where it is directed. An offer to sell is accepted in this State if the offeree communicates acceptance to the offeror in this State and acceptance is received where it is directed.

(d) This [Act], except Sections 501(a), 502(a), and 503, also applies to a franchise or business opportunity offered or sold outside this State if it is offered or sold to a resident of this State and is to be conducted in this State.

(e) If a franchise is subject to this [Act] under subsection (d), Sections 302 through 305 are satisfied if the franchisor, at the time specified either in Section 302(b) or the franchise disclosure law of the other state, delivers to the offeree an offering circular substantially complying with Section 303 or with the franchise disclosure law of the other state.

(f) If a business opportunity is subject to this [Act] under subsection (d), Sections 402 through 404 are satisfied if the promoter at the time specified

either in Section 404(b) or the business opportunity law of the other state delivers to the offeree a disclosure document substantially complying with Section 403 or with the business opportunity law of the other state.

(g) An offer to sell is not made in this State solely because the offer appears in a newspaper or other publication of general and regular circulation if the publication has had more than two-thirds of its circulation outside this State during the 12 months before the offer is published or the offer appears in a broadcast or transmission originating outside this State.

COMMENT

Subsection (e): A person offering or selling a franchise outside this State to a resident of this State for operation in this State must deliver a complete offering circular under the corresponding franchise law of the sister state to avoid the applicability of Sections 302 through 305 under subsection (d).

SECTION 103. WAIVER VOID.

A party to a franchise or business opportunity may not waive a right or benefit conferred, or avoid a duty imposed, by this [Act] or by a rule or order under this [Act] except to settle a bona fide dispute or claim asserted under this [Act], or as permitted by Section 306. A settlement of an actual or potential dispute or claim may include a general release.

COMMENT

An individually negotiated modification to a franchise, permitted under Section 306, is not in violation of Section 103. A standard "integration" clause of a franchise agreement cannot negate a material misrepresentation made to induce the purchase of the franchise and would be a violation of Section 103.

SECTION 104. NONJUDICIAL RESOLUTION OF DISPUTES.

Parties to a franchise or business opportunity may agree to arbitration, mediation, or other nonjudicial resolution of an existing or future dispute.

SECTION 105. OTHER LAW.

(a) Principles of law and equity, including capacity to contract, estoppel, fraud, misrepresentation, duress, coercion, and mistake, supplement this [Act].

(b) This [Act] does not limit (i) rights, privileges, remedies, or duties that may exist under other law, or (ii) the power of this State to punish a person for conduct constituting a crime under other law.

COMMENT

Over the course of a long-term business relationship, the terms of the parties' written agreement can be modified by subsequent conduct. Subsection (a), accordingly, preserves such doctrines as oral modification and practical construction of contracts, tolling, promissory estoppel, and forum non conveniens. See, e.g., Williston on Contracts, Third Edition, Sections 1828 (Written Contracts May Be Varied By Subsequent Oral Agreement) and 1880 (Cancellation Of

Contracts Enforced By Equity); Huver v. Opatz, 392 N.W.2d 237 (Minn. 1986). Compare UCC § 2-208.

SECTION 106. UNCONSCIONABILITY.

(a) If a court, as a matter of law, finds a franchise or business opportunity or a provision of either to have been unconscionable when it was made, the court may so limit the application of the unconscionable provision as to avoid an unconscionable result, or it may enforce the remainder of the agreement without the unconscionable provision, or if necessary it may refuse to enforce the agreement.

(b) Before making a finding of unconscionability under subsection (a), the court, on motion of a party or its own motion, shall afford the parties a reasonable opportunity to present evidence as to the setting, purpose, application, and effect of the agreement, provision, or conduct complained of.

COMMENT

1. This section does not prevent a court from granting preliminary injunctive relief. Subsection (b) requires a court to take evidence only as a prerequisite to finding a contract term to be unconscionable. A summary finding that a provision of a franchise or business opportunity is not unconscionable is permitted by Section 106.

2. Section 106 is based upon the corresponding provisions of Article 2 of the Uniform Commercial Code. The standard of unconscionability, articulated in subsection (a), is applied as of the time of the formation of the contract, but may be established by evidence that includes subsequent conduct. Frivolous or groundless claims of unconscionability are not addressed by this Act but may be dealt with under general rules of civil procedure.

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SECTION 107. NONRETROACTIVITY.

This [Act] does not apply to a claim for relief arising before the effective date of this [Act].

SECTION 108. SHORT TITLE.

This [Act] may be cited as the "Uniform Franchise and Business Opportunities Act".

SECTION 109. APPLICATION AND CONSTRUCTION.

This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among states enacting it. This [Act] shall be liberally construed to effectuate its purposes.

SECTION 110. EFFECTIVE DATE.

This [Act] takes effect on [_____, _____, 19__].

COMMENT

At least 180 days should be allowed from enactment before the Act takes effect. The effective date should be stated as a date certain.

SECTION 111. SEVERABILITY.

If a provision of this [Act] or its application to a person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] that can be given effect without the invalid

provision or application, and to that end the provisions of this [Act] are severable.

SECTION 112. REPEALS.

The following acts and parts of acts are repealed:

(1)

(2)

(3)

COMMENT

Section 112 repeals are appropriate for states with existing franchise registration or disclosure laws, business opportunities laws, or franchise relationship regulation laws. Existing state law regarding registration or disclosure in connection with offers or sales of franchises and business opportunities, and relationship laws of general applicability, should be repealed. Conforming cross-references and coordinating language and exemptions should be enacted in state securities law, unfair trade practices law, and similar enactments. Existing law applicable only to specific industries or types of distribution relationships should be reexamined and either repealed or coordinated with this Act where appropriate, especially Articles II and III.

ARTICLE II

GENERAL STANDARDS OF CONDUCT

SECTION 201. DUTY OF GOOD FAITH.

A franchise or business opportunity imposes on the parties a duty of good faith in its performance and enforcement. "Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.

COMMENT

1. Section 201 follows Restatement (Second) of Contracts Section 205 and the Uniform Commercial Code Section 2-103. It imposes a contractual duty upon parties to a franchise or business opportunity, and arises upon the formation of the agreement. The section is intended to prevent arbitrary, malicious, or abusive conduct, or conduct that deprives the other contracting party of the benefit of the bargain, and to preserve the justifiable expectations of the parties to a franchise or business opportunity relationship. It does not apply in the give and take of bargaining preceding the formation of the agreement. It is not intended to eliminate risk.

Section 201 establishes an obligation on all parties to a franchise or business opportunity when dealing with other parties to the relationship to act in a manner that is commercially reasonable in the particular trade. This section does not create a fiduciary standard. A franchise is a business arrangement. See Bain v. Champlain Petroleum Co., 692 F. 2d 43 (8th Cir. 1982), and Picture Lake Campground, Inc. v. Holiday Inns, Inc., 497 F. Supp. 858 (E.D. Va., 1980). The duty of good faith is based upon the common law principle authoritatively articulated in Kirke Lashelle Co. v. Paul Armstrong Co., 88 N.E. 163 (NY 1933), and more recently reaffirmed in Division of Triple T Service, Inc. v. Mobil Oil Corp., 311 N.Y.S. 2d 961 (1970). See also Pappas Co. v. E. & J. Gallo Winery, 610 F. Supp. 662 (E.D. Cal. 1985). The duty is imposed to modify and limit the exercise of discretion or power reserved in a contract, rather than to add to or override substantive provisions of a contract,

especially in longer term relational contracts which must, by their nature, reserve significant discretionary authority to provide marketing flexibility over the term of the arrangement. It precludes a party from recapturing economic benefits forgone in the process of contracting. See Goetz and Scott, "Principles of Relational Contracts," 67 Virginia L.R. 1089 (1981) and Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith," 94 Harvard L.R. 369 (1980).

The duty prohibits one contracting party from depriving another of the benefit of the bargain. American Business Interiors, Inc. v. Haworth, Inc., 798 F. 2d 1135 (8th Cir. 1986); Conoco, Inc. v. Inman Oil Co., Inc., 774 F. 2d 895 (8th Cir. 1985).

The Act relies on the duty of good faith rather than offering a code of prohibited or mandatory substantive actions or practices to govern the business relationship of parties to a franchise or business opportunity. More than two years of intense study and debate by the Drafting Committee, which considered all existing statutes on termination, nonrenewal, and related issues, as well as several original drafts that attempted to list prohibited and mandatory practices, led the NCCUSL to the conclusion that a list of prohibitions could not be expressed in a manner that was evenhanded, economically efficient, or responsive to the interests of consumers and of other franchisees or business opportunity operators. The NCCUSL also was concerned that the Act remain sufficiently flexible to be fair and appropriate over the enormous range of industrial sectors and geographic markets in which franchising is being employed and in which business opportunities may come to be employed as a legitimate production or distribution technique. Precommitment disclosure of contract terms under Articles III and IV combined with Sections 505 and 506 will substantially reduce the risks of overreaching and surprise in franchise and business opportunity relationships, further reducing the need for a code of prohibited practices.

Section 201 does not abrogate, or codify, principles of promissory estoppel, oral modification, or other legal or equitable doctrines affecting the formation, performance, or enforcement of contracts. See Section 105(a). Specific facts and circumstances may give rise to other duties not stated in Section 201. Matter of Sbarro Holding, Inc. (Yuan), 445 N.Y.S. 2d 911 (N.Y. Sup. Ct. 1981).

2. Parties to a franchise or business opportunity may not waive or exclude the duty of good faith by agreement or by conduct. See Section 103.

3. Courts are expected and encouraged to apply Section 201 flexibly in accordance with evolving standards of commercial behavior. See Sections 105 and 106.

4. The principles underlying Section 201 are reflected in the results of such cases as Photovest Corp. v. Photomat Corp., 606 F. 2d 704 (7th Cir. 1979) (predatory conduct taken to destroy a business operated pursuant to a franchise actionable under federal antitrust law and a common law duty of good faith); Larese v. Creamland Dairies, Inc., 767 F. 2d 716 (10th Cir. 1985) (a contractually reserved discretion may not be exercised arbitrarily if the power to act arbitrarily has not been expressly reserved by the contract); Conoco, Inc. v. Inman Oil Co., Inc., 774 F. 2d 895 (8th Cir. 1985) (duty of good faith precludes conduct that unjustifiably deprives the other party to a contract of the benefit of its bargain); and Atlantic Richfield Co. v. Razumic, 480 Pa. 366, 390 A. 2d 736 (1978) ("reasonable expectations" of parties and "principles of good faith and commercial reasonableness" invoked to prevent "arbitrary" termination-nonrenewal of dealer franchise that was silent regarding franchisor's right to terminate at will). Amoco Oil Co. v. Burns, 496 Pa. 336, 437 A. 2d 381 (1981) and Zapatha v. Dairy Mart, Inc., 408 N.E. 2d 1370 (Mass. 1980) (express contractual right to terminate at will upheld in the absence of showing of surprise, usurpation of funds, loss of investment, or other overreaching or unfair or deceptive practices) are consistent with Section 201.

Section 201 is also consistent with the analysis in Kestenbaum v. Falstaff Brewing Corp., 514 F. 2d 690 (5th Cir. 1975), at 696, of a producer's right to restrict the class of those it will accept as assignees of its dealers, and therefore limit the selling price of one of its dealerships, in a sale by an existing dealer, to provide the buyer a chance to realize a return on its investment.

While this Act does not apply to dealerships that are not "franchises," Section 201 also reflects the legal principles developed in a line of common law cases relating to termination of dealerships, represented by: de Treville v. Outboard Marine Corp., 439 F. 2d 1099 (4th Cir. 1971) (principles of equity and good conscience, broader than principles of fraud

or duress, limit a contractually reserved right to terminate at will); Tele-Controls, Inc. v. Ford Industries, Inc., 388 F. 2d 48 (7th Cir. 1967) (duty of good faith applies to contractual right to terminate at will); Alpha Distrib. Co. of California, Inc. v. Jack Daniel Distillery, Inc., 454 F. 2d 442 (9th Cir. 1972) (at will termination of oral distributorship for an indefinite term permitted absent fraud, threats of violence, or defamation); Randolph v. New England Mutual Life Insurance Co., 526 F. 2d 1383 (6th Cir. 1975) (contract clause allowing at will termination of a fixed term agency contract cannot be exercised in "bad faith").

5. Section 201 does not establish a "good cause" rule. Compare Kealey Pharmacy and Home Care Service, Inc. v. Walgreen Co., 761 F. 2d 345 (7th Cir. 1985) (nondiscriminatory termination of all dealerships while preserving corporate outlets, pursuant to a right expressly reserved in a written contract, held to violate statutory "good cause" standard for termination).

SECTION 202. RIGHT OF FREE ASSOCIATION.

A party to a franchise or business opportunity has a right to form or join a trade or other lawful association whose purposes are related to the business of the franchise or business opportunity.

COMMENT

A party to a franchise or business opportunity has a right to associate with other members of the same system or others similarly situated to advance their common business interests, and may not be penalized for doing so. This section does not insulate conduct that is anticompetitive, or detrimental to the goodwill of a trademark licensed in the relationship, and it does not create independent substantive contractual rights or a duty to bargain.

ARTICLE III

FRANCHISE DISCLOSURE

SECTION 301. EXEMPTIONS.

(a) An offer or sale of a franchise is exempt from Sections 302 through 305 if it is:

(1) by a franchisor and (i) the franchisor has sold no more than three franchises in all states within the preceding 12 months, (ii) the franchisor does not publish an advertisement for that franchise, and (iii) the buyer is represented in the transaction by legal counsel, or a certified public accountant, independent of the franchisor;

(2) by a franchisor and (i) the purchaser, or one of the purchaser's officers, directors, partners, or principals, has had two or more years of experience in the line of business in which the franchise will be operated, and (ii) the purchaser and the franchisor reasonably expect that sales derived by the franchisee from the franchise will constitute less than 20 percent of the franchisee's total sales in all lines of business during the first 12 months of operation of the franchise;

(3) to an officer, director, partner, principal, or affiliate of the franchisor, and the offer is not pursuant to a public offering;

(4) in exchange for one or more existing franchises and the terms and conditions of the exchange are approved by a court pursuant to the United States Bankruptcy Code;

(5) by or to a state or a subdivision of a state or other governmental agency; or

(6) by a franchisee, including a subfranchisor selling the entire master franchise, for the franchisee's account and the sale is not effected by or through the franchisor.

(b) A sale for purposes of subsection (a)(6) is not effected by or through the franchisor solely because the franchisor has or exercises a right to consent to the transaction, to approve or disapprove a proposed buyer of the franchise, or to charge a transfer fee under the franchise.

COMMENT

1. Caution should be exercised in transactions that may be exempt under Section 301 but not under the FTC Rule (16 CFR Part 436).

2. The exemption in subparagraph (a)(2) is based upon the "fractional franchise" exemption from the FTC Rule, which assumes that investors with the prescribed level of experience and lack of dependence on the franchise do not need customary precommitment disclosure. All business interests of the franchisee are to be taken into account in determining the universe against which the 20% standard is to be applied.

3. The bankruptcy exemption is based on the idea that contractual exchanges supervised by a bankruptcy court do not require the precommitment disclosure required under other circumstances.

SECTION 302. PRECOMMITMENT DISCLOSURE.

(a) A person may not offer or sell a franchise in this State without furnishing the prospective franchisee at the time required by subsection (b) an offering circular complying with Section 303.

(b) A franchisor shall furnish an offering circular to a prospective franchisee at the earliest of (i) ten business days before the prospective franchisee executes an enforceable agreement relating to the franchise, (ii) ten business days before the franchisor receives consideration for the franchise, or (iii) the first personal meeting held with the prospective franchisee for the purpose of discussing the offer or sale of the franchise.

(c) A signature on an acknowledgment of receipt for an offering circular by an officer or agent of a corporation or by a general partner in a partnership is effective as against the corporation and its shareholders or the partnership and its partners.

(d) The franchisor shall furnish to the prospective franchisee a completed copy of the franchise agreement and each related agreement not later than five business days before its execution. This subsection does not require postponement of execution of the agreements if changes in the agreements are made at the request of the prospective franchisee.

(e) A franchisor who receives from a prospective franchisee consideration or a signed document relating to the franchise earlier than is permitted by subsection (b) does not violate this section if the franchisor immediately and unconditionally returns the consideration or document.

(f) Furnishing an offering circular complying with Section 303 not less than ten business days before the franchisor accepts consideration or an enforceable agreement from a prospective franchisee cures (i) a previous inadvertent failure to furnish to the prospective franchisee an offering circular complying with Section 303 or (ii) an inadvertent failure to furnish an offering circular at the time required by this section.

(g) Subsections (b) and (d) are satisfied if the offering circular and agreements are furnished in compliance with applicable requirements of the Federal Trade Commission Trade Regulation Rule on Franchising and Business Opportunity Ventures. [A change in delivery requirements under the Federal Trade Commission Rule which is promulgated after the effective date of this [Act] becomes effective for purposes of this Article 90 days after its promulgation, unless the [Administrator] by rule earlier finds the change to be inconsistent with this [Act].]

COMMENT

1. Subsection (b) is based upon the Federal Trade Commission Trade Regulation Rule on Franchising and Business Opportunity Ventures (16 CFR Part 436). The "first personal meeting" rule of subsection (b) is a variation of the parallel requirement of the FTC Rule.

2. The first sentence of subsection (d) is based on the parallel requirement of the Federal Trade Commission Rule (16 CFR Part 436). The requirement as to related agreements applies to agreements to be entered into essentially contemporaneously with the franchise and does not apply to agreements entered into later during the term of the franchise.

3. Subsection (f) rejects the holding of Ciampi v. Red Carpet Corp. of America, et al., 167 Cal. App. 3d 336 (Cal. Ct. App. 1985), to the effect that erroneous disclosures that violated the state franchise disclosure law could not be corrected by a subsequent accurate disclosure that preceded the purchaser's payment of a fee or execution of an enforceable agreement. Because this section applies only to inadvertent errors, it does not permit rectification of knowing or intentional violation of this Article.

4. The bracketed language in subsection (g) is only for states where automatic acceptance of future revisions in the FTC Rule might constitute an unconstitutional delegation of legislative or administrative authority. To enhance uniformity, Administrators should follow a strong presumption against modifying or rejecting changes.

SECTION 303. OFFERING CIRCULAR.

(a) The offering circular required by Section 302(a) must contain:

(1) a statement of all material information relating to the franchise, the franchisor, and the circumstances of the offering;

(2) except as provided in subsection (d), a copy of the franchisor's most recent audited financial

statements, including statements of income and loss for the franchisor's most recent three fiscal years;

(3) a specimen of each agreement proposed for use in connection with the franchise; and

(4) duplicate acknowledgment of receipt pages to be signed and dated by the prospective franchisee, one of which, when completed, must be detached and retained by the franchisor.

(b) The cover of the offering circular must state conspicuously that the [Administrator] has not approved, recommended, or endorsed the franchise described in the offering circular and that the [Administrator] has not reviewed the offering circular or the adequacy or accuracy of the information contained in the offering circular.

(c) A franchisor that is a subsidiary of another person may use the audited financial statements of the other person to satisfy subsection (a)(2) if (i) the person whose audited financial statements are used has unconditionally guaranteed in writing all franchise obligations of the franchisor and the offering circular so states, and (ii) the franchisor also includes in the offering circular its balance sheet, which may be unaudited, as of a date within 90 days before the date of the offering circular.

(d) Unaudited statements of income and loss may be used under subsection (a)(2), but only to the extent

audited statements have not been made. If an unaudited statement of income and loss is used, it must be clearly and conspicuously labeled as unaudited. Audited statements of income and loss must be used as soon as practicable but not later than 120 days after the end of the franchisor's first full fiscal year after the date on which the franchisor must comply with this Article.

(e) This section is satisfied by a Uniform Franchise Offering Circular prepared in accordance with the Guidelines for the Preparation of the Uniform Franchise Offering Circular promulgated by the North American Securities Administrators Association or its successor, or by a disclosure document prepared in accordance with the content and format requirements of the Federal Trade Commission Trade Regulation Rule on Franchising and Business Opportunity Ventures. [A change in the requirements for the Uniform Franchise Offering Circular or for disclosure documents under the Federal Trade Commission Rule which is promulgated after the effective date of this [Act] becomes effective for purposes of this Article 90 days after its promulgation, unless the [Administrator] by rule earlier finds the change to be inconsistent with this [Act].]

(f) This section is satisfied by delivery of a single offering circular complying substantially with

this section or with the franchise disclosure law of another state if this [Act] and the similar laws of the other state have concurrent application.

COMMENT

1. Subsection (a)(3): The requirement as to each agreement proposed for use in connection with the franchise applies to agreements to be entered into essentially contemporaneously with the franchise, and does not apply to agreements entered into later during the term of the franchise.

2. Subsections (c) and (d): The term "financial statements" is used in its common accounting sense, denoting a balance sheet, a statement of income and loss, a statement of changes in financial condition, and notes. The term "audited" means examination of the financial statements in accordance with generally accepted auditing standards, and expression of an opinion on the financial statements, by an independent certified or licensed public accountant.

3. Subsection (d) is based upon the "phase-in" rule for audited financial statements under the Federal Trade Commission Rule (16 CFR Part 436).

4. The bracketed language in subsection (e) is only for states where automatic acceptance of future revisions in either disclosure format by its promulgating agency might constitute an unconstitutional delegation of legislative or administrative authority. Administrators should use a strong presumption against modifying or rejecting changes.

SECTION 304. CHANGES.

A franchisor shall promptly revise its offering circular to reflect a material change in the information it contains. If an offering circular is revised under this section, the franchisor, before selling a franchise to a prospective franchisee who received an earlier version of the offering circular,

shall deliver a revised offering circular to the prospective franchisee not later than two business days before the franchisor accepts consideration or an enforceable agreement from the prospective franchisee. The prospective franchisee, on the advice of its legal counsel, may waive the two-business-day requirement.

SECTION 305. NOTICE TO [ADMINISTRATOR].

(a) Before offering or selling a franchise in this State, a franchisor or subfranchisor shall file with the [Administrator] a notice that states the name of the franchisor, the name under which the franchisor conducts business, and the franchisor's telephone number and principal business street address.

(b) While a franchisor continues to offer or sell franchises in this State, the franchisor shall immediately notify the [Administrator] of any change in the information contained in the franchisor's notice on file with the [Administrator].

(c) A notice filed under subsection (a) remains in effect until modified or withdrawn by the franchisor or canceled by the [Administrator].

(d) The [Administrator] may cancel a notice filed under subsection (a) upon finding that the franchisor cannot be located at the address or telephone number stated in the notice. Cancellation is without prejudice to the franchisor's right to file a

new notice and does not invalidate an offer or sale made before the franchisor receives notice of the cancellation. The [Administrator] shall notify a franchisor that its notice has been canceled by mailing a notice of cancellation stating the factual grounds for the cancellation to the address stated in the franchisor's notice and to another address, if any, at which the [Administrator] has reason to believe the franchisor is more likely to receive the notice.

COMMENT

In addition to filing a notice under subsection (a), a franchisor must file a consent to service of process under Section 502(a) and pay the filing fee under Section 511.

SECTION 306. NEGOTIATED CHANGE PERMITTED.

This Article does not preclude negotiation of the terms and conditions of a franchise before or after it is sold. A franchisor need not amend its offering circular to negotiate with an offeree, or make supplementary disclosure to that offeree, by reason of a change negotiated in the terms and conditions of a franchise.

COMMENT

1. This section rejects the policies adopted by some state franchise administrators that the terms of franchise agreements cannot be negotiated to differ from what was presented in the offering circular, or cannot be negotiated without a cumbersome amendment and redisclosure process. One of the principal purposes of precommitment disclosure is to give a prospective investor information to make an informed investment decision, and to bargain for the best and most suitable

terms available. Such negotiation in individual cases does not require separate, prior, or serial disclosures to the offeree. The franchisor's willingness to bargain on certain terms of the offering may itself be material information that should be disclosed in the offering circular.

2. A pattern of negotiating variations of the same terms may call into question the accuracy of the offering circular's disclosure of the terms of the offering. Where a disclosure item is required to reflect whether certain features of franchises offered contemporaneously are uniform, such as in the area of initial and continuing franchise fees, an individual negotiation may give rise to a duty to modify the offering circular subsequently provided to others.

3. No inference should be drawn from the absence from Article IV of a counterpart to Section 306.

ARTICLE IV

BUSINESS OPPORTUNITIES

COMMENT

See Comment to Section 101(5), regarding the differing definition in this Act of "business opportunity" from that in the FTC Rule (16 CFR Part 436). The exemptions provided in Section 401 and the exclusions provided in Section 101(5) do not correspond precisely to those in the FTC Rule.

SECTION 401. EXEMPTIONS.

(a) The following are exempt from this Article:

(1) a disposition of goods or services to a business that has been engaged for at least six months in distributing other goods or services not supplied by or through the promoter or its affiliate or designee, if the parties reasonably expect the goods or services supplied by the promoter or its affiliate or designee

to constitute less than one-third of total sales by the purchaser during the first 24 months after the disposition;

(2) a disposition of goods or services in connection with the sale of an ongoing business or segment of a business that has actively conducted the business for six months next preceding the disposition; or

(3) an offer or sale of a business opportunity by or to a state or a subdivision of a state or other governmental agency.

(b) A business opportunity is exempt from Sections 402 through 409 and Section 411 if (i) it is offered by a promoter whose net worth exceeds $5,000,000 according to the promoter's most recent audited balance sheet as of a date within 15 months before the transaction, or (ii) the promoter is 80 percent or more owned by another person whose net worth exceeds $5,000,000 according to its most recent audited balance sheet as of a date within 15 months before the transaction and that person in writing unconditionally guarantees the promoter's performance.

COMMENT

1. Exemption under subsection (a) is only from Article IV, and not from other provisions of the Act, including Section 505.

2. Businesses that are subject to comprehensive regulation under other statutes may petition the

Administrator under Section 501 for exemption from all or part of Article IV.

SECTION 402. REGISTRATION REQUIRED.

(a) A promoter who proposes to offer or sell a business opportunity in this State shall first register the offering with the [Administrator].

(b) The promoter shall file with the [Administrator] an application for registration. The [Administrator] by rule shall prescribe the form for the application. The form must require the promoter to state the promoter's name, the name under which the promoter conducts business, the promoter's organizational form and the jurisdiction in which it is organized if the promoter is not an individual, the promoter's telephone number, the promoter's business street address, the name and address of each person who offers the business opportunity, and a brief description of the business opportunity being offered. The application must be accompanied by a specimen of a proposed disclosure document complying with Section 403, a consent to service of process required under Section 502(a), and the filing fee prescribed by Section 511, and other information the [Administrator] requires by rule or order.

(c) If the [Administrator] finds the filing to be complete and has no reason to believe the disclosure document is in violation of Section 403 or 505(a) and

there is no order outstanding under Section 405(a), the [Administrator] shall issue an order of registration of the business opportunity offering. The business opportunity offering becomes registered automatically on the 22nd day after the application for registration is filed if the [Administrator] has not issued an order granting or denying registration. The [Administrator] may not routinely ask applicants for registration to waive or defer the automatic registration of an offering.

(d) Registration remains effective until it is canceled by the promoter or canceled or suspended by the [Administrator]. A promoter may withdraw its application or cancel its registration by notice to the [Administrator].

COMMENT

The effectiveness of Article IV rests primarily on the requirement of pre-offer registration by the promoter of the business opportunity offering. Experience demonstrates that irresponsible or dishonest operators in fact do not register, but the failure to do so provides a ready, unambiguous ground upon which the Administrator may move against fraudulent promoters. The Administrator in such cases is not put to the burden of showing the fraudulent nature of the particular offering. Registration review by the Administrator does not constitute merit review of the offering.

SECTION 403. DISCLOSURE DOCUMENT.

(a) The disclosure document required under Section 404 must set forth all material facts and circumstances relating to the business opportunity, the

identity and background of the promoter and its directors, officers, general partners, affiliates and designees, and the circumstances of the offering. The disclosure document must contain the most recent audited financial statements of the promoter as of a date within 15 months before the offering is registered, and a specimen of each agreement proposed for use in connection with the business opportunity.

(b) The [Administrator] by order may require that additional information be contained in a disclosure document or filed with the [Administrator].

(c) The [Administrator] shall accept as complying with this section as to format (i) a disclosure document prepared in accordance with the requirements of the Federal Trade Commission Trade Regulation Rule on Franchising and Business Opportunity Ventures, (ii) a disclosure document prepared in accordance with a uniform disclosure format promulgated by the North American Securities Administrators Association or its successor, or (iii) a disclosure format approved for use by five or more states. [A change in the requirements for disclosure under the Federal Trade Commission Rule or the North American Securities Administrators Association or state-approved disclosure format which is promulgated after the effective date of this [Act] becomes effective for purposes of this Article 90 days after its promulgation

unless the [Administrator] by rule earlier finds the change to be inconsistent with this [Act].]

(d) The disclosure document must set forth conspicuously on its cover a statement substantially reproducing Section 406(a).

(e) The disclosure document must contain duplicate acknowledgment of receipt pages to be signed and dated by the prospective purchaser, one of which, when completed, must be detached and retained by the promoter.

COMMENT

1. The bracketed language in subsection (c) is for states where automatic acceptance of future revisions in a disclosure format by its promulgating agency might constitute an unconstitutional delegation of legislative or administrative authority. Administrators should use a strong presumption against modifying or rejecting changes.

2. No inference should be drawn from the absence of a counterpart in Article IV to Section 306. See Sections 103 and 411.

SECTION 404. FURNISHING DISCLOSURE DOCUMENT.

(a) A person may not offer or sell a business opportunity in this State without furnishing to the prospective purchaser at the time required under subsection (b) a copy of a disclosure document on file under Section 402 and complying with Section 403.

(b) The promoter shall furnish the disclosure document to the prospective purchaser at the earliest of (i) ten business days before the prospective

purchaser executes an enforceable business opportunity agreement, (ii) ten business days before the promoter or its affiliate or designee receives consideration for the business opportunity, or (iii) the first personal meeting held with the prospective purchaser for the purpose of discussing the offer or sale of the business opportunity.

(c) Subsection (b) is satisfied if the disclosure document is delivered in accordance with the requirements relating to the time for making disclosure in the Federal Trade Commission Trade Regulation Rule on Franchising and Business Opportunity Ventures. [A change in the delivery requirements under the Federal Trade Commission Rule which is promulgated after the effective date of this [Act] becomes effective for purposes of this Article 90 days after its promulgation, unless the [Administrator] by rule earlier finds the change to be inconsistent with this [Act].]

COMMENT

1. The "first personal meeting" rule of Section 404(b) is a variation of the parallel requirement of the Federal Trade Commission Trade Regulation Rule (16 CFR Part 436).

2. The bracketed language in subsection (c) is only for states where automatic acceptance of future revisions in the FTC Rule might constitute an unconstitutional delegation of legislative or administrative authority. To enhance uniformity, Administrators should follow a strong presumption against modifying or rejecting changes.

SECTION 405. DENIAL, SUSPENSION, OR CANCELLATION OF REGISTRATION.

(a) The [Administrator] may issue an order denying, suspending, or canceling a registration under Section 402 if the [Administrator] reasonably believes that (i) the registration filing or disclosure document is incomplete or contains a false or misleading statement or omits material information, or (ii) the applicant or its affiliate has violated or is about to violate this Article. The order must state the factual grounds for its issuance.

(b) The [Administrator] may vacate or modify an order if conditions that led to its issuance have changed or the action is otherwise in the public interest. The [Administrator] shall state the factual grounds for the vacation or modification.

COMMENT

Subsection (b) does not authorize the Administrator to conduct merit review of business opportunity offerings. The reference to the public interest facilitates changes in administrative policy independent of the facts of a particular matter. See Comment to Section 509(d).

SECTION 406. EFFECT OF REGISTRATION.

(a) Registration under this Article does not mean that a document or application filed under this Article is true, complete, or not misleading, or that the [Administrator] has approved, recommended, or endorsed the business opportunity, or reviewed the

disclosure document or the adequacy or accuracy of the information contained in the disclosure document.

(b) A person may not make a representation inconsistent with subsection (a).

(c) A promoter may not refer to its compliance with this Article in connection with an offer or sale of a business opportunity, except to state that the offering of the business opportunity is registered in this State.

COMMENT

Subsection (c) should be interpreted to prohibit a promoter from employing a representation concerning the provision of financial assurance under Section 408(a)(3) or 409.

SECTION 407. CHANGES IN REGISTRATION AND DISCLOSURE DOCUMENT.

(a) A promoter of a registered business opportunity offering shall promptly notify the [Administrator] of (i) a material change in information contained in the promoter's application for registration or disclosure document and (ii) information necessary to make statements in the application or disclosure document true, complete, and not misleading in the circumstances or context in which they are made. Notification must be made by an application to amend the disclosure document or the application for registration, accompanied by the filing

fee required by Section 511 and a revised application or disclosure document.

(b) A promoter shall promptly revise its disclosure document to reflect any material change in the information it contains. A promoter shall revise its disclosure document by substituting new audited financial statements in the disclosure document not later than 120 days after the end of the promoter's fiscal year.

(c) If the [Administrator] finds the application to amend to be complete and has no reason to believe the amended disclosure document is in violation of Sections 403 or 505(a) and there is no order outstanding under Section 405(a), the [Administrator] shall issue an order of amended registration. The amended registration and disclosure document become effective automatically on the 15th day after the application to amend is filed if the [Administrator] has not issued an order granting or denying the application. The [Administrator] may not routinely ask applicants for amendment to registration to waive or defer the automatic registration of an amendment.

SECTION 408. MINIMUM STANDARDS.

(a) If a promoter or its affiliate, in connection with the offer or sale of a business opportunity, makes a representation that it will refund

or repurchase, as described in Section 101(5)(i)(C)(I) or (II), the promoter shall:

(1) include the representation in the disclosure document required by Section 404;

(2) include in the business opportunity agreement required by Section 411 a specific statement of the terms and conditions of the refund or repurchase provision and of the promoter's unqualified and enforceable obligation to the purchaser to honor the provision; and

(3) provide financial assurance in conformity with Section 409.

(b) If a purchaser invokes a refund provision described in Section 101(5)(i)(C)(I), the promoter shall immediately refund the purchaser's initial payment plus the purchase price of all goods or services the purchaser obtained from the promoter or its affiliate or designee under the business opportunity which the purchaser makes available to the promoter.

(c) If the purchaser invokes a repurchase provision described in Section 101(5)(i)(C)(II), the promoter shall immediately repurchase from the purchaser (i) all items the purchaser obtained from the promoter or its affiliate or designee under the business opportunity, and (ii) all goods produced, grown, or modified, or services rendered, by the

purchaser using goods or services supplied by the promoter or its affiliate or designee, in each case for the greater of its fair market value or the amount represented in the business opportunity.

SECTION 409. FINANCIAL ASSURANCE.

(a) A promoter who makes a representation that it will refund or repurchase, as described in Section 101(5)(i)(C)(I) or (II), shall obtain a bond or irrevocable letter of credit, or establish an escrow account, complying with this section. The promoter shall file with the [Administrator] a copy of the bond or letter of credit or file a notice stating the name of the depository and the account number of the escrow account.

(b) A surety bond must be written by a corporate surety authorized to do business in this State, under terms and conditions established by the [Administrator] by rule or order and be in favor of the [Administrator] for the benefit of persons damaged by failure to perform a refund or repurchase obligation as described in Section 101(5)(i)(C)(I) or (II) by the promoter or its affiliate or designee, and also directly in favor of persons so damaged.

(c) A letter of credit must be issued or confirmed by, and an escrow account must be established

in, a state or national [bank] located in this State, under terms and conditions established by the [Administrator] by rule or order.

(d) In addition to the person's other rights and remedies, a person damaged by failure to perform a refund or repurchase obligation, as described in Section 101(5)(i)(C)(I) or (II), has a claim for relief against the promoter and against an affiliate or designee of the promoter who violates this Article or the business opportunity. The person damaged also has a claim for relief against the surety, issuer, or confirming [bank], or escrow agent on the bond, letter of credit, or escrow account, for an amount equal to 50 percent of the initial payment made by the person damaged. The aggregate liability of the surety, issuer, or confirming [bank], or escrow agent to all persons damaged by failure to perform a purchase or refund obligation by a promoter or its affiliate or designee is limited to the amount of the bond, letter of credit, or escrow account. The surety, issuer, or confirming [bank], or escrow agent is not liable for punitive or exemplary damages awarded against the promoter or its affiliate or designee.

(e) The amount of the bond, letter of credit, or escrow account must exceed the greater of $10,000 or 50 percent of the total amount of the initial payments under all business opportunities the promoter has

entered into in this State during the preceding 12 months that include a refund or repurchase provision as described in Section 101(5)(i)(C)(I) or (II). As necessary, the promoter shall adjust the amount of financial assurance monthly during the first six months of its operations in this State and quarterly thereafter. The total amount of the financial assurance need not exceed $300,000. Except to the extent of outstanding obligations, the promoter may cancel the escrow account or terminate an outstanding bond or letter of credit [90] days after the promoter ceases to offer the business opportunity in this State, but cancellation of the account or termination of the bond or letter of credit is without prejudice to rights or claims of purchasers then accrued.

COMMENT

1. Subsection (c): "Bank" is bracketed to allow discretion to enacting states to add reference to savings and loan associations or to change the reference to "regulated financial institution" or similar designation as may be appropriate in that state.

2. Subsection (d): This Act takes no position on the advisability of punitive damages generally, but in no case should they be awarded against one who acts in effect as a trustee for affected investors, or from the funds held by that person.

3. Subsection (e): The $300,000 maximum amount of financial assurance relates only to the bond, letter of credit or escrow under Section 411 and does not limit the total liability or obligation of the promoter.

SECTION 410. CERTAIN PRACTICES PROHIBITED.

(a) A promoter or its affiliate may not represent that a business opportunity provides income, profit, or earning potential of any kind or amount unless the promoter has a documented reasonable basis for the representation. The promoter shall disclose information concerning the earnings claim to the purchaser in accordance with the requirements of the disclosure document format the promoter selected under Section 403(c), or a disclosure format approved by the [Administrator] by rule.

(b) A promoter or its affiliate may not use the trademark, service mark, trade name, advertising, or other commercial symbol of another person who does not either (i) own a controlling interest in the promoter or (ii) unconditionally guarantee in writing all representations made by the promoter in regard to the business opportunity, unless the nature of the promoter's relationship to that person is set forth immediately adjacent to and with equal prominence to the depiction of the commercial symbol of that person. This subsection does not prohibit a promoter from using a trademark of a trade association of which the promoter is a member or a certification mark in accordance with its requirements and federal trademark law.

(c) A promoter or its affiliate or designee may not take a negotiable instrument, other than a check, as evidence of the purchaser's obligation unless the instrument on its face negates holder in due course status of its holder.

(d) A business opportunity agreement may not require payment of more than 25 percent of the initial payment before delivery to the purchaser of the goods to be supplied by the promoter or its affiliate or designee unless the portion greater than 25 percent is placed in escrow to be held until the purchaser advises the escrow agent in writing of the delivery of the goods or the promoter presents the escrow agent with a bill of lading or receipt signed by the purchaser which proves delivery of the goods. The purchaser may not unreasonably withhold notice of delivery.

SECTION 411. REQUIREMENTS FOR AGREEMENT.

(a) The promoter shall reduce each business opportunity to a written agreement. The agreement must state legibly:

(1) the terms and conditions of the purchaser's rights and obligations, including the initial payment, additional payments, and any down payment required;

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(2) a detailed description of the acts or services the promoter or its affiliate or designee undertakes to perform for the purchaser;

(3) the promoter's name, telephone number, principal business street address, and the name and address of its agent in this State authorized to receive service of process;

(4) the business form of the promoter and the jurisdiction of its incorporation or organization;

(5) the estimated delivery dates of each installment and whether the goods or services are to be furnished to the purchaser at premises owned or managed by the purchaser or at premises owned or managed by persons other than the purchaser;

(6) the terms and conditions of any refund or repurchase obligation of the promoter under Section 408(a);

(7) the name and address of the suppliers of the goods and services the promoter or its affiliate or designee is to furnish to the purchaser; and

(8) a conspicuous notice, in substantially the following form, that the purchaser has the following rights and obligations:

Cooling Off Period

If you change your mind, you have three business days in which you may cancel this agreement.

To cancel, you must mail or deliver a written notice to

_____

(Seller's name and street address)

by _____ (last date to mail or deliver notice). If mailed, the notice must be postmarked by the above date. Or, if you deliver the notice, it must be delivered by the end of the normal business day on the above date.

If you cancel, we must promptly refund your payments, and, until the fifth business day after you receive your refund, you must allow us to pick up anything we provided to you under this agreement.

If you cancel, we may deduct from your refund the price of goods we delivered to you that you do not return or make available for us to pick up.

Other Rights

If we mislead you in connection with the offer or sale of this business opportunity, or if we fail to deliver goods or perform services promised to you, you may have certain rights, including the right to cancel. Consult a lawyer or [name of state agency].

(b) A promoter shall furnish to the purchaser when the purchaser signs them a copy of the completed agreement and all other documents the promoter requires the purchaser to sign. If the promoter or its affiliate does not sign the agreement or other documents at the same time as the purchaser, the

promoter also shall furnish signed copies to the purchaser promptly after the promoter or its affiliate signs them.

COMMENT

A business opportunity can be created and come under the Act even if only in oral form (Section 101(5)), but it is a violation of Section 411 to fail to reduce it to a written agreement.

SECTION 412. PRESERVATION OF RIGHTS.

A successor or assignee of the promoter's interest or rights in a business opportunity is subject to all rights, claims, and defenses of the purchaser against the promoter or its affiliate or designee.

SECTION 413. PURCHASER'S RIGHT TO CANCEL.

(a) A purchaser has the rights described in Section 411(a)(8), including the right to cancel described in that paragraph, whether or not they are contained in an agreement with the promoter.

(b) If a promoter or its affiliate fails to comply with this Article, or uses, in connection with the offer or sale of a business opportunity, a false or misleading statement of a material fact or omits material facts necessary to make the statements made, in the circumstances in which they are made, not misleading, a purchaser affected, within one year after the date of the business opportunity agreement, may

cancel the business opportunity and related agreements by written notice to the promoter.

(c) If a promoter or its affiliate inadvertently fails to make disclosures required under this Article or inadvertently uses a business opportunity agreement that fails to comply with this Article, the promoter may furnish the purchaser with the correct disclosure statement or correct agreement and a written notice that the purchaser may cancel the agreement within 30 days after receipt of the correct disclosures or agreement. The notice must state the purchaser's right to receive a refund under subsection (e). If the purchaser does not cancel the business opportunity within the 30-day period, the purchaser may not later base cancellation of the agreement on violations corrected by the new disclosure document or agreement.

(d) If a promoter or its affiliate or designee within one year after the date of the business opportunity agreement fails to deliver goods or perform services within 30 days after the delivery or performance date stated in the agreement, the purchaser may give notice of the failure to the promoter, and, if the delivery is not made within 30 days after the notice or the promoter fails to show that the failure to deliver was due to causes beyond its control, the purchaser may cancel the business opportunity by written notice to the promoter.

(e) If a purchaser cancels under this section, the promoter shall promptly refund all amounts paid by the purchaser under the business opportunity, less the price or fair market value, whichever is less, of goods delivered to the purchaser by the promoter or its affiliate or designee and not returned or made available to the promoter. For five days after receipt of the refund, the purchaser shall make available to the promoter the goods delivered by the promoter or its affiliate or designee.

ARTICLE V

ADMINISTRATION; PROHIBITED PRACTICES; REMEDIES

SECTION 501. RULEMAKING.

(a) Except as limited in Section 510(d), the [Administrator] may promulgate in accordance with the [Administrative Procedure Act] rules necessary to implement this [Act]. In order to enhance uniformity among the states, the [Administrator] shall take into account the rules of other states on the same subject.

(b) The [Administrator] may exempt transactions and persons, and classes of transactions and persons, from one or more of Sections 302, 303, 304, 305, 402, 403, 404, 409, and 411 upon finding that the exemption is consistent with this [Act] and in the public

interest and that compliance with those sections is not necessary for the protection of prospective franchisees or purchasers.

SECTION 502. SERVICE OF PROCESS.

(a) A person who offers or sells a franchise or business opportunity in this State shall file with the [Administrator] an irrevocable consent to service of process appointing the [Administrator] as the person's agent to receive service of process in a civil action or proceeding arising under this [Act].

(b) A person who offers or sells a franchise or business opportunity in this State without filing a consent to service of process is deemed to appoint the [Administrator] as the person's agent to receive service of process in a civil action or proceeding arising under this [Act].

(c) A person may effect service of process under this section by service on the [Administrator]. The time to respond begins to run when the person sends notice of the service and a copy of the process by certified mail to the defendant or respondent at its last address on file with the [Administrator]. If no address is on file with the [Administrator], the time to respond begins to run when the process is served on the [Administrator]. The plaintiff shall file an

affidavit of compliance with this section with the court or tribunal hearing the matter.

SECTION 503. RECORDS.

A person who offers or sells a franchise or business opportunity shall maintain records of sales and offers directed to specific persons made in this State and keep them for four years after the date of the offer or sale. The records must contain the signed acknowledgment of receipt for each disclosure document delivered to a prospective purchaser under Article III or IV. Those records must be made available to the [Administrator] at the office of the [Administrator] on demand of the [Administrator]. Records required by this section may be kept on photographic or electronic media but must be printed out if the [Administrator] requests.

SECTION 504. ACCESS TO INFORMATION.

Documents filed with the [Administrator] under this [Act] are documents of public record.

SECTION 505. MISREPRESENTATION PROHIBITED.

(a) A person may not offer or sell a franchise or business opportunity in this State by means of a false or misleading statement of a material fact or omission of a material fact necessary to make the

statements made, in the circumstances in which they are made and taking into account all information available to the prospective purchaser, not materially misleading.

(b) Information is material if it would reasonably be expected to influence a prospective purchaser of a franchise or business opportunity to purchase or forgo the purchase of the franchise or business opportunity. The determination of materiality must be made with reference to all information available to the prospective purchaser.

SECTION 506. CIVIL LIABILITY.

(a) A person injured or threatened with injury by a violation of this [Act] or a rule promulgated or order issued under this [Act] has a claim for relief for damages caused by the violation and other appropriate relief.

(b) The court may award reasonable attorney's fees to a person who prevails in an action or proceeding under this [Act].

COMMENT

1. Subsection (a): "Appropriate relief" may include declaratory judgment, customary forms of equitable relief, such as injunctive relief (mandatory or prohibitory), or rescission in appropriate circumstances, taking into account the duration of the relationship, the harm suffered, the wilfullness of the violation and similar factors.

2. Despite hortatory language in the FTC's Guides to the Trade Regulation Rule (16 C.F.R. Part 436), a private right of action is not available under the FTC Rule. Chelson v. Oregonian Publishing Co., 1981-1 Trade Cas. (CCH) ¶ 64,031 (D. Ore. 1981); Freedman v. Meldy's, Inc., 587 F. Supp. 658 (E.D. Pa. 1984). This section provides for private recourse, although a private cause of action may also be available under other state law such as a "little FTC" Act or other general unfair trade practices act. See Section 105.

3. A causal relationship must exist between the violation complained of and the injury alleged. This Act takes no position on whether or not punitive damages should be awarded or, except as provided in Section 507, issues relating to the burden of proof.

4. Section 506 is not the exclusive source of relief. See Section 105.

SECTION 507. BURDEN OF PROVING EXEMPTION.

In a civil action or proceeding under this [Act], the burden of proving an exemption is on the person claiming it.

SECTION 508. LIMITATION OF ACTIONS.

A civil action or proceeding for a violation of this [Act] may not be maintained unless commenced before the earlier of one year after the plaintiff discovers the facts constituting the violation or three years after the act or transaction constituting the violation.

COMMENT

1. The one year limitations period commences when the plaintiff either (i) becomes aware of facts or circumstances reasonably indicating that the plaintiff has a claim for relief against the defendant in regard to conduct governed by applicable provisions of Article II, III, or IV, rather than upon the plaintiff's mere

awareness of certain facts, or (ii) reaches a specific legal conclusion that this Act has been violated.

2. This section is a statute of limitations and is subject to such doctrines as tolling, waiver, and equitable estoppel.

SECTION 509. JURISDICTION.

A civil action or proceeding arising out of a franchise or business opportunity may be commenced wherever jurisdiction over the parties and subject matter exists, even if the agreement limits actions or proceedings to a designated jurisdiction or venue. The doctrine of inconvenient forum must be considered.

SECTION 510. ACTION BY [ADMINISTRATOR].

(a) If the [Administrator] reasonably believes that a person has violated or is about to violate Article III or IV or Section 505, the [Administrator] may issue an order to cease and desist from practices that violate or would violate Article III or IV or Section 505 and may [maintain an action] [request the Attorney General to maintain an action] in the [general jurisdiction] court to enjoin the acts or practices or to enforce compliance with Article III or IV or Section 505. Upon a proper showing, the court may grant a permanent or preliminary injunction, a restraining order, or other appropriate relief and may appoint a receiver or conservator for the defendant or the defendant's property. The court may not require the

[Administrator] [Attorney General] to post a bond.

(b) The [Administrator] may make public or private investigations in or outside this State to aid in the enforcement of Article III or IV or Section 505 and to aid in the promulgation, amendment, or repeal of rules or issuance, modification, or vacation of orders, or to determine whether a person has violated or is about to violate Article III or IV or Section 505. The [Administrator] may subpoena persons to testify or produce evidence in connection with an investigation. The [Administrator] may share the findings of an investigation with other public agencies and officials. The [Administrator] may publish the findings of an investigation but may not be compelled to do so.

(c) The [Administrator] shall refer information or evidence concerning a violation or impending violation of Article III or IV or Section 505 to [the Attorney General] [and to] [the prosecuting attorney of the county in which the violation occurred or is about to occur]. The [Attorney General] [and the] [prosecuting attorney], with or without a reference, may commence appropriate criminal proceedings.

(d) The [Administrator] may not promulgate rules or issue orders under, or take action to enforce, Sections 105 or 106, or Article II.

[(e) The [Administrator] shall conduct investigations or proceedings in accordance with the

[Administrative Procedure Act], and the [Administrator] has the powers and duties designated in the [Administrative Procedure Act].]

COMMENT

1. A state should select the bracketed language in subsection (a) that reflects its normal allocation of prosecutorial responsibilities.

2. A court may require a receiver or conservator to post bond as a condition to obtaining equitable relief under subsection (a).

3. The Administrator's authority to issue a cease and desist order may be exercised ex parte in emergency situations, subject to any limitations set forth in the State's Administrative Procedure Act.

4. Section 510(d) is included to prevent the Administrator from prescribing by rule a list of prohibited practices or other substantive regulation of the relationship between franchisor and franchisee, and seller and buyer of a business opportunity, which should be left to the common law and interpretations of Article II. See Comment to Section 201. The Administrator similarly has no authority to prescribe by rule substantive relationship regulations under Sections 105 and 106.

5. Subsection (e) is optional for states where application of the Administrative Procedure Act to this Act is not clear.

SECTION 511. FEES.

(a) The [Administrator] shall charge the following fees:

(1) For filing a notice under Section 305(a), $[25];

(2) For filing a change notice under Section 305(b), $[10];

(3) For filing a business opportunity registration application under Section 402, [$100]; and

(4) For filing an application to amend a business opportunity registration under Section 407, $[50].

(b) The [Administrator] may establish by rule reasonable fees to cover the actual costs of photocopying or other services under this [Act].

[SECTION 512. CRIMINAL LIABILITY.

A person who violates Article III or IV or Section 505 with intent to defraud in connection with the offer or sale of a franchise or business opportunity is guilty of [insert the language for felony under applicable law].]

COMMENT

Section 512 is optional for states whose existing criminal law does not deal adequately with economic crime. Criminal liability, however, should attach only to conduct undertaken with an intent to defraud.

TESTIMONY RE FRANCHISE TERMINATION LEGISLATION--AUG. 4, 1988

BARRY KELLMAN*

INTRODUCTION

With nearly a half trillion dollars in annual sales and representing 2/7 of the Gross National Product, franchising hardly needs this law professor to extol its importance in the American economy. Franchising has come a long way in a short time since the Supreme Court but two decades ago described it as an aberrational form of doing business.[1]

Franchising has grown because franchising is an efficient system of distributing many products and services. Like the corporate form of doing business which burst upon the American scene in much the same fashion a century ago, franchising has succeeded because it offers very real economic incentives. However, like the early evolution of the corporate form, franchising has caused a number of serious problems which lawmakers must address.

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* Professor of Law, Cleveland State University Law College, Cleveland, Ohio.

1. In United States v. Arnold, Schwinn & Co., 388 U.S. 365, the Court opined:

> If the manufacturer parts with dominion over his product or transfers risk of loss to another, he may not reserve control over its destiny or the conditions of its resale. To permit this would sanction franchising and confinement of distribution as the ordinary instead of the unusual method which may be permissible in an appropriate and impelling competitive setting, since most merchandise is distributed by means of purchase and sale.

In my testimony, I will repeatedly draw analogies from franchising law to corporate law. I believe that many of the problems generated by franchising are in fact analogues of problems faced by those who invest in corporate securities. Indeed, the reform I call for at the conclusion at my testimony--the grant of appraisal remedies to terminated franchisees on the basis of going concern value as a continuing franchise--derives exactly from the slowly evolving doctrine of corporate law which holds that shareholders forced to surrender possession of their stock are entitled to similar appraisal rights.

I will make no effort to cover the panoply of legal concerns affecting franchising;[2] but for purposes of organization, let me suggest that many problems affecting franchising can be put into two categories. First, there are the problems affecting the solicitation and recruitment of franchisees and the need for disclosure regulations. Second, there are the problems of termination and transfer of the franchise relationship. While my testimony is directed at this second set of problems, let me make a few comments on disclosure requirements.

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2. For an encyclopedic treatment of the problems of franchising, *see*, Brown, FRANCHISING REALITIES AND REMEDIES (1981).

PROBLEMS OF FRANCHISE SOLICITATION--DISCLOSURE LAWS

Currently, fifteen states have enacted laws requiring registration and/or disclosure of information prior to the sale of franchises. These laws generally require that the prospective franchisor prepare an elaborate offering circular which must be registered with a state franchise administration and which may only be circulated to prospective franchises after a waiting period, usually ten days. Included among the required disclosures in the offering circular are detailed recitals of the franchisor's background and finances, as well as the mechanics of its franchise system. Most states with franchise laws allow civil liability under private causes of action for any violation of the applicable statute.[3]

The growing state regulation of the sale of franchises, with diverse and sometimes conflicting requirements, has led to the drafting of the Uniform Franchising Offering Circular Guidelines ("UFOC").[4] The UFOC requirements attempt to introduce a degree of uniformity in to the disclosure required before a franchisor may seek to sell franchises under state statutes and regulations. However, as the UFOC has not been uniformly adopted and since each state may

3. *See generally,* Sutherland, *The Risks and Exposures Associated with Franchise Noncompliance,* 42 BUS. LAWYER 369 (1987).
4. For a detailed analysis, *see,* Zeidman, Ausbrook and Lowell, FRANCHISING: REGULATION OF BUYING AND SELLING A FRANCHISE, BNA Corporate Practice Series #34 (1983).

interpret the UFOC requirements and guidelines differently, the result remains a lack of total uniformity.

During the 1970s, numerous bills introduced in Congress would have required full disclosure, but no such legislation was passed. The most significant regulation affecting the buying and selling of franchises is the Federal Trade Commission's rule: "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures."[5]. The Rule applies to the sale of franchises in all fifty states and requires disclosure of specified material information to prospective franchisees. It does not, however, require registration or filing with the Commission or with any other agency. Nor does it purport to affect the substantive terms of the franchisor-franchisee relationship.

A cursory review of the literature evaluating the FTC Rule indicates widespread support. Actual and potential franchisees reportedly used the disclosure documents required by the FTC and found them useful in making their decisions.[5] Correspondingly, most franchisors believe that disclosure adds credibility to the franchisors' image and helps in defense of potential claims by franchisees.[6] Calls for reform tend to focus on three issues: (1) making

5. *A Study of the Impact of the Franchise Disclosure Rule on Franchisees and Potential Investors,* 58 BUS. FRAN. GUIDE (CCH).
6. *Final Report of a Survey to Evaluate the Economic Impact on Franchisors of the FTC Trade Regulation Rule,* _____ BUS. FRAN. GUIDE (CCH).

disclosure of earnings information made mandatory; (2) requiring registration of disclosure information with the Commission; and (3) establishment of a private right of action for remedying violations of the Rule. Congress should consider the desirability of uniformity in disclosure laws. Like the federalization of securities disclosure law in the 1930s, federalization of franchise disclosure law centralizes regulatory attention--of benefit to franchisors and to franchisees alike.

The FTC Rule requiring disclosure has a long history of successful case by case challenges against deceptive acts and practices in the sale of franchises. Deception, however, is not the only problem of franchising. Necessarily, disclosure regulation can do little to control the ongoing relationship and, most important, the ending of the franchise relationship. It is to these set of problems that I would like to turn.

PROBLEMS OF TERMINATION--THE BALANCE OF POWER

I strongly believe that the starting point of an analysis on the problems throughout the franchise relationship must begin with the gross power disparity between the parties. Advantages in bargaining power, financial strength, and access to information and advice lead to one-sided franchise agreements which can be presented on a take-it-or-leave-it basis. During the relationship, each franchisee faces in the threat of

termination the possible loss of his capital investment. In jeopardy is his chance to earn a living as a franchisee and even thereafter if he is subject to a post-term non-competition covenant.

The termination of business dealings is likely to have dire consequences for the franchisee. If he has an exclusive dealership and sells only one manufacturer's products, then the termination in effect puts him out of business unless he can obtain the business of another franchisor quickly. Whatever expenditures and efforts he has made toward building the goodwill of the product are rendered worthless as the rewards of that work are given to another franchisee. Even if the franchisee carries other lines, the impact of a termination is likely to be severe. Obviously, as the franchisor's share of the franchisee's business declines, the ability of the franchisee to survive increases. But the termination can almost always be said to inflict hardship on the franchisee. How often do we see a franchisee terminating a franchisor?

The franchisor's power to terminate can be translated into the power to coerce behavior under threat of termination. The franchisor and the franchisee each are aware of the consequences of termination, and that knowledge is a power in itself. Thus, whatever advantage the franchisor's superior bargaining power established at the outset of the relationship, as performance continues that

advantage shifts even further toward the franchisor because the more time, effort, and capital the franchisee spends promoting the product, the more reticent he becomes to lose the advantage of the relationship and the more power the franchisor has over him.

Closely related to the problem of termination is the problem of renewal. Ultimately, all franchises come up for renewal. The equity built in the business by the franchisee is, at that point, in jeopardy, as the franchisor may be totally free to deny renewal. At any time during the relationship, the franchisee may die, become disabled, or decide to sell or give away his franchise. Restrictions requiring that the transfer be approved by the franchisor are often used to obtain valuable assets for a depressed price, leaving the franchisee, or often his family, with little to show for a lifetime of effort.

The extensive list of abusive treatment by franchisors has been extensively probed by Congress in regard to the Mikva Bill of the 94th Congress[7]. That investigation revealed that unfair treatment results not only from schemes based on deception or inherent fraud. Business abuses, probably in far greater number, characterize legitimate

7. H.R. 8349, 94th Cong., 1st Sess. (1975). This bill was substantially reintroduced in the 95th Congress as H.R. 5016. A more expansive statute was proposed in the 96th Congress as H.R. 2305, also known as the Franchise Reform Act. For a discussion of the various Congressional efforts to regulate franchise terminations, *see*, Braun, *Policy Issues of Franchising*, 14 SOUTHWESTERN UNIV. L. R. 155 (1983).

franchising networks. In many cases, a franchisor was found to have engaged in a deliberate strategy of lowering the value of the franchise through unfair practices, reacquisition by exercising a right of termination, and reselling the franchise at a substantial profit or holding it as a company-owned outlet.

The other side of the argument should not be ignored. There may be very good reasons for a franchisor to terminate a franchisee or to restrict its transfer. The franchisee may have failed to transact business sufficiently well to meet competition. Perhaps, the franchisee failed to meet reasonable sales quotas. If the franchisee fails to promote the product adequately, refuses to provide necessary services to consumers or is lax in pushing for new sales, the franchisor should be able to terminate without fear of legal liability.

The task of any serious effort at reform must be to maintain the right of franchisors to manage their franchise network in their best competitive judgment including affording them the right to determine who shall be their franchisees, with the right of every franchisee to receive the full rewards of his efforts. However, existing law is not directed toward that goal.

PROBLEMS OF TERMINATION--"GOOD CAUSE" STATE STATUTES

Currently, almost all states have laws regulation termination, cancellation, and non-renewal of franchises. While these statutes differ on significant details, they share in common a vague substantive standard sometimes referred to as good cause, good faith, just provocation, not unfair. While these slippery terms are often not defined at all, one discernible legal proposition is that the interest held by the franchisee or the franchisor in the business that is the subject of the franchise should not be appropriated or capriciously damaged by the other party.[8] What is clear is that these state statutes have generated an awesome and bewildering array of litigation leaving the judiciary with the thankless task of determining on a case by case basis whether the termination is legally permissible. As one commentator has suggested:

> The good cause statutes allow a franchisor--after litigation--essentially to do that which he could also do with an unrestricted power of termination--but without litigation...By requiring case-by-case adjudication to establish a franchisor's right to do what an unrestricted power of termination would also allow him to do, state and federal 'good cause' statutes impose a heavy burden in terms of litigation costs.[9]

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8. *See,* Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir. 1979), *cert. denied,* 445 U.S. 917 (1980); and Michael Todd & Co. v. Lacal Co., 583 F.2d 1056 (8th Cir. 1978).
9. Lockerby, *Franchise Termination Restrictions: A Guide for Practitioners and Policy Makers,* 30 ANTITRUST BULLETIN 791 (1985).

This "good faith" standard is also found in the Automobile Dealers Franchise Act[10], which permits an automobile dealer to sue for damages sustained by reason of the manufacturer's failure "to act in good faith in performing or complying with any of the terms of provisions of the franchise, or in terminating, cancelling, or not renewing the franchise." This good faith standard has been narrowly constructed to prohibit only coercion or intimidation--i.e. a wrongful demand backed by sanctions. A simple refusal to deal, even if arbitrary, is not actionable. The courts, when called upon to interpret the Dealer's Day in Court Act, have continually held that failure to act in good faith meant something more than hard bargaining on the part of the manufacturer.[11] Furthermore, a valid cause for termination is not an absolute defense. Thus, the act extends protection to inefficient and undesirable dealers while inadequately protecting the hard-working dealer whose non-renewal deprives him of his rightful equity.

The Petroleum Marketing Practices Act[12], , sets forth in far more detail the circumstances which permit non-renewal or termination of a covered franchise. Termination

10. 15 U.S.C. s1221-1225.
11. *See generally,* Donovan, *Federal Laws Affecting The Right of a Franchisor to Terminate or Not Renew a Franchise: Automobile Dealers Day In Court Act,* 49 ANTITRUST LAW JOURNAL 1353 (1980).
12. 15 U.S. C. ss2801 *et seq.*

without cause is strictly forbidden. Termination with cause is limited to five situations; nonrenewal to an additional four. While most of the grounds for termination or nonrenewal involve some form of franchisee misconduct, the Act also permits termination or nonrenewal because of certain distributor business decisions. These reasons are sufficiently broad to encompass most of the parties' relationship. The subjective good faith test used by the courts grants considerable discretion to franchisors in citing a cause for termination.[13] Typically, it is where the franchisor has failed to comply with the notice provisions of the statute--rather than the failure to establish good cause--that a successful claim under the act may be made.[14]

The Petroleum Marketing Practices Act allows terminations, provided they are for good cause, but has not been interpreted to require an accounting to the dealer of the equity inherent in the premises. The Third Circuit's recent decision in *Slatky v. Amoco Oil Co.*,[15] may suggest a more enlightened approach. At issue was how an oil company franchisor must satisfy (and in what manner courts should scrutinize) the statutory requirement that the franchisor

13. *See generally,* O'Brien, *Federal Laws Affecting The Right of a Franchisor To Terminate or Not Renew a Franchise: Petroleum Marketing Practices Act,* 49 ANTITRUST LAW JOURNAL 1371 (1980).
14. *See,* Lippo v. Mobil Oil Corp., 776 F.2d 706 (7th Cir. 1985) (franchisee's misbranding of gasoline was not good cause for termination without notice and allowance of ten days to cure).
15. 830 F. 2d 476 (3rd Cir. 1987).

must make a "bona fide offer" to sell to the franchisee the leased property used by the franchisee in his business. The court ruled that as a matter of law, the offer must be objectively reasonable, i.e., that it approach fair market value.

PROBLEMS OF TERMINATION--ANTITRUST LAWS

By far the most important body of law to terminated franchises is federal antitrust law. However, with its focus on the promotion of competitive conditions, antitrust law is mismatched to the task of providing fairness for persons involved in the franchising relationship. Franchise restrictions originally raised antitrust concerns as a derivation of government anti-monopoly efforts to prevent possessors of significant market power from extending or fortifying that power by restraining independent dealers. Antitrust law has long recognized that while competition does not occur between producers and dealers and that protection of dealers is not per se an antitrust goal, restraints imposed as part of a vertical relationship can adversely affect competition. It was precisely this concern which led to passage of Section 3 of the Clayton Act which prohibits vertical distribution restraints where goods (rather than services) are involved, and where the effect may be to substantially lessen competition or tend to create a monopoly. The Sherman Act prohibits every distribution

restriction arrangement which restrains trade or constitutes an attempt to monopolize.

In recent years, the fear that monopolists will leverage their power by imposing restraints upon distribution has given way to the realization that distribution restraints are often imposed by firms lacking market power in order to enhance a sophisticated and efficient distribution system. As a consequence, an overwhelming quantity of antitrust litigation brought by terminated dealers shows conclusively that the termination of a dealer is, in and of itself, legal. A producer can incur antitrust liability only if the termination was causally connected to an act or restriction which itself is anti-competitive in purpose or effect. Dealer terminations are culpable acts only if the termination was the manifestation of an otherwise anticompetitive scheme. Thus, terminations for failure to comply with illegal tying arrangements, exclusive dealing arrangements, or re-selling restrictions may give rise to antitrust concern if the producer has market power and if the restriction is the result of coercive use of that power.[16]

Recent Supreme Court decisions have made proof of an antitrust violation difficult for the terminated franchisee. First and most important, a terminated dealer must introduce "evidence that tends to exclude the possibility that the

16. *See*, Kellman, *Vertical Territorial Restrictions and The Limits of Planning*, 46 ANTITRUST LAW JOURNAL 1107 (1978).

manufacturer and nonterminated distributors were acting independently."[17] The producer may rebut the evidence tending to prove that the sole purpose of the termination was to eliminate a price cutter by offering evidence that it was motivated by legitimate, nonprice-related reasons. Earlier this year, the Supreme Court in *Business Electronics Corp. v. Sharp Electronics Corp,*[18] held that an agreement between a manufacturer and a dealer to terminate a price cutter without a further agreement on the price or price levels to be charged by the remaining dealer is not antitrust actionable. Thus, only where the anticompetitive price fixing scheme is demonstrable, will the terminated dealer have an antitrust cause of action.

PROBLEMS OF TERMINATION--DAMAGES FOR WRONGFUL TERMINATION

Under current law, state or federal, where a termination has been found to be wrongful, the terminated dealer, although obliged to mitigate damages by reasonable substitution of product lines, may recover damages for injury to business, whether measured by its lost net total profits or damage to the value of its business.[19] These standards may be measured in one of three ways: (1) the before and after approach, which compares a plaintiff's profit or loss in two distinct time periods, using his own

17. Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752, 764 (1984).
18. 1988-1 Trade Cases P67,982 (1988).
19. *See generally,* Rulon, *Proof of Damages for Terminated or Precluded Plaintiffs,* 49 ANTITRUST LAW JOURNAL 153 (1980).

business and its performance to calculate damages; (2) the yardstick theory, which compares the plaintiff's profits during the period of the unlawful conduct to the profits of a similar company that was not adversely affected by the unlawful conduct; and (3) the market share theory, which calculates the market share lost by plaintiff in dollars multiplying that dollar volume by plaintiff's profit margin. Of course, damages must be proved with reasonable certainty; neither their existence nor their amount may be speculative.[20] The question of which valuation approach is proper is essentially a factual one; each case ultimately resting on its own facts.[21]

SOLVING THE PROBLEM--PERMITTING TERMINATIONS FOR FAIR VALUE

What is needed is a system which recognizes the unique nature of the problem, and approaches it from a consistent theoretical framework while applying to it a logical remedy. The difficulty of this task is how to adjust the equities of the parties to a franchise relationship once the decision has been made to discontinue the relationship.

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20. Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd., 416 F.2d 71 (9th Cir. 1969), *cert. denied*, 396 U.S. 1062 (1970); and C.A. May Marine Supply Co. v. Brunswick Corp., 649 F.2d 1049 (5th Cir.), *cert. denied*, 454 U.S. 1125 (1981). *See generally*, Faruki, *The Defense of Terminated Dealer Litigation: A Survey of Legal and Strategic Considerations*, 46 OHIO STATE LAW JOURNAL 925 (1085).

21. Eiberger v. Sony Corp. of America, 622 F.2d 1068 (2d Cir. 1980).

Every franchise agreement contains elaborate provisions governing two related matters: the franchisee's right to transfer his franchise; and termination and renewal of the franchise. These are the most important provisions in the whole agreement since they limit what the franchisee may do with his capital asset--the going value of the business that he may have spent years in developing.

The good cause bills fundamentally represent that franchise cancellation is a matter of contract law: permissible when in conformity with the terms of the agreement; impermissible when motivated by bad faith. From this beginning, the rules of the game have been developed; failure to prove to a judge's or administrative board's satisfaction that the facts surrounding a specific cancellation merits its placement in the "for cause" category results in a penalty being applied.

To the contrary, more is a stake here than the standard sales agency relationship. The parties' relationship extends beyond the contract and more is mutually expected than the "best efforts" duty of sales law.[22] The franchisor demands that quality stands be maintained and trusts the franchisee to uphold its local image. The franchisee needs the national expertise in training and advertising along with the uniform product that gives the trademark a public identity. Each party has an investment in the enterprise

22. U.C.C. s2-306(2).

and mutually depends upon this blend of independent local service with the uniform national character of the product for its success.

The proper approach must have as its goal the ultimate dissolution of the relationship. From the outset, the relationship is founded upon mutual trust and a desire to work together toward a common goal, namely a net profit. The decision to terminate means that, for whatever reason, at least one of the parties no longer has that desire. Any approach which ignores this crucial fact overlooks the very essence of the franchising relationship.

It would be better to allow cancellation in all cases. The parties should be free to come and go for whatever they feel are just reasons. The termination process itself should be monitored, however, The franchisee should be compensated for his losses, the most substantial of which is the loss of the right to do business. In other words, if the effect of a disparity in bargaining power confers unreasonable gains upon termination, then the law should provide that those gains are split equitably. Thus, upon cancellation, the franchisee should receive exactly what he would have received from a voluntary sale--the fair market value of the business.

In the franchise situation, if every termination required a payment to the franchisee an amount equal to the fair market value of the business, each decision would be

assessed independently, as it should, from a strictly business frame of reference. If it is more profitable to keep the outlet in operation than to buy it out, then no termination would ensue. By choosing the fair market value of the business as the remedy, franchise terminations would be removed from the judicial arena and returned to the business sector. Indeed, once an appraisal is completed, the court's role is over. The relationship is ended, and each party receives its fair share.

SOLVING THE PROBLEM--MEASURING FAIR VALUE

The measure of fair market value is no more difficult than the measure of damages in termination litigation. Thus, if the franchise were purchased or a good faith offer to purchase were received immediately prior to the termination, the price paid or the offer made would be the best and most direct evidence of going-concern value of the business. When actual or negotiated market price evidence is not available, going-concern value is usually determined as the present value of a projected stream of future profits, discounted at the appropriate discount rate. The net profit of the outlet over the forecasted life of the business is the most important item to be calculated into that value. The salary drawn by the individual operator as well as the franchise or license royalties should be considered a part of the profit.[23] These projected future

23. Generally, antitrust damages theory does not provide for loss of the owner's salary, *but see,* Taxi Weekly, Inc.

profits must be discounted at an appropriate rate to determine a present value. The discount rate should reflect the risk involved in the business.

The measure of goodwill is perhaps the most difficult aspect of such an appraisal. The local goodwill inherent in the site and the local outlet's contribution to the goodwill in the trademark should be allocated to the franchisee. To place a value on good will, excess profits--profits generated by the business that are greater than the profits likely to be generated by other business in the same industry subject to the same elements of risk and uncertainty--are capitalized.

Going-concern value will fully compensate the terminated franchisee only where, upon termination, the franchise is intact. Where some or all of the franchise's value has been lost by reason of the termination or because of controversy preceding termination, the value which reflects what a third person would pay for the business may require supplementation. It may be conceded that many hard accounting questions require resolution, but it may also be suggested that those questions are better confronted in an appraisal process than in litigation over the motive of the termination.

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v. Metropolitan Taxicab Board of Trade, 539 F.2d 907 (2d Cir. 1976) (part of compensation which is entrepreneurial profit may be included in the calculation of damages).

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Finally, it should be noted that there is nothing new in the idea advanced herein. The late Senator Philip H. Hart of Michigan, proposed the "Franchise Competitive Practice Act,"[24] which provided that if a franchisor terminated without the consent of the franchisee, or at expiration refused to renew the franchise, the franchisor would be liable to pay the franchisee the market value of premises and equipment of the franchisee utilized in the marketing of the franchisor's products or services, the costs of the franchisee's inventory purchased from the franchisor, and further, the reasonable value of the franchise, including goodwill, as well as the reasonable value of customers' accounts of the franchisee which were preempted by the franchisor. As in regard to so many policy matters, Senator Hart was well ahead of his time. I suggest that the 101st Congress re-consider this proposal.

24. S. 2321, 90th Cong., 1st Sess. (1967).

TESTIMONY
BEFORE THE SUBCOMMITTEE
ON ANTITRUST, IMPACT OF DEREGULATION AND PRIVATIZATION
AUGUST 4, 1988

KATHRYN L. BOE
ASSISTANT TO THE PRESIDENT
CREIGHTON UNIVERSITY
AND
ASSISTANT DEAN, SCHOOL OF LAW
CREIGHTON UNIVERSITY

It is an honor to be here. You have asked me to address six questions.

I. Discuss stages of a franchise relationship and the problems encountered in each.

The franchisor/franchisee relationship can be divided into four (4) stages: 1) evaluation; 2) start-up; 3) established; and 4) termination/expiration/renewal.

1) Evaluation of the Franchise Opportunity

This is the stage of introductions, franchisor to franchisee - each seeking to know the other. For each party the main problems are associated with the ability to obtain and to analyze sufficient data to evaluate the business opportunity effectively. The prospective franchise is greatly helped by the Federal Franchise Rule (16 C.F.R. 436 et. seq.) which requires that data be provided to the prospective franchisee at the earlier of the first "personal meeting" or ten (10) business days before any contracts are signed or any money changes hands. The data required by the Rule concerns the business experience of the franchisor and the specific characteristics of the franchise being offered. This information is essential to make a reasoned decision about the franchise. The information is presented in a well organized format specified by the Federal Rule.

The problem in this regard is that the prospective franchisee needs more data than is provided by the document. First, he needs to know whether there is a real market niche for this product or service in the location which he is considering. Second, he needs a thorough knowledge of himself, his goals, and his abilities. And, third, he needs some kind of educated guess about the profitability of the undertaking in order to compare this business opportunity with other uses of his assets including simply banking the money.

The first kind of information - that dealing with market niche - will be speculative under the best of circumstances. The franchisor may not want to make claims which could later turn out to be so optimistic as to constitute fraud. And few would-be franchisees will do any independent homework in this regard beyond scouting existing franchises to count customers.

The second type of information - that regarding the individual's goals, abilities, and personality - may surface during the franchisor's application process. That is what the franchisor in a good system intends. But, depending on how hungry the franchisor is, such niceties may easily be "lost in the shuffle."

Thirdly, obtaining information on prospective earnings may be well nigh impossible. As pointed out recently, "...it is a question that is seldom answered by companies selling franchises. Federal and state laws permit, and even encourage this question to go unanswered." (Warren L. Lewis, "How Much Can You Expect to Earn?" Franchising World, Vol. 20, No. 4 'July/August 1988,' p. 20).

But we all know from the FTC's own studies that about one in three franchise prospects gets earnings claims, anyway ("A Study of the Impact of the Franchise Disclosure Rule on Franchisees and Potential Investors," prepared for the FTC by Audits and Surveys, Princeton, New Jersey, August, 1984, p. 3). Since more than half of these are "under the table" (i.e., not made or substantiated in an Earnings Claims Document) the information is often questionable at best. In summary, the regulatory approach to providing this information has been so far from ideal as to be unworkable.

Merely obtaining the missing information is not enough, however. The prospective franchisee must be able to understand and evaluate the information presented to him. SBA statistics indicate that thousands of new businesses are opened in this country each year. Far too few of those hope-filled entrepreneurs have been able to evaluate the market data and their own finances. The franchisee is better off in this regard than his free-lance counterpart since federal and state laws require that much information be provided. Even for the prospective franchisee, however, it is at this juncture that professional advice is most needed. An accountant should analyze the obligations of the deal and the franchisee's finances. A lawyer should go over the Disclosure Document and Contract. Since many franchises have terms of from ten (10) to twenty (20) years, the prospective franchisee is considering one of the longest relationships in his life. It well behooves him to thoroughly understand its obligations and his ability to meet them.

Although the federal rule is written in such a way that clarity is encouraged, the FTC's own study on the impact of the Disclosure Document indicates that most prospective franchisees turn the document over to others for advice. Without this help, many would simply depend on the gloss of sales brochures.

2) The Start-Up Franchisee

Once the Disclosure Document is delivered, the initial fee turned over to the franchisor, and the Contract is signed those pieces of magic legal paper are usually filed and forgotten. The major problems now relate to training. New franchisors may not have had the time or resources to develop good training programs and written manuals. But franchisee success now is totally dependent on the thoroughness of the Training Program Manuals and following support. Some psychologists claim that in a learning situation, no matter how hard you try, you won't be able to remember more than 15% of what is said. Those of us who teach can reluctantly confirm this. In the franchise context, this means that the Operations Manuals must be succinct, clear, thorough, and correlated with the training course. If not, they may be useless.

But this is also the stage which is probably most expensive for the franchisor. Establishing a good training program, producing effective materials, and implementing the program is expensive in time and money. The training generally includes not only an extended session at the franchisor's home office, but also substantial field assistance in the establishment of the franchisee's business premises and Grand Opening.

By the time the franchisee has been in business a few months the franchisor may very well have provided services which in their direct and indirect costs exceed the entire initial franchise fee. As a matter of fact, in many systems the initial franchise fee is actually "a wash."

3. The Established Franchisee

Gradually the new franchisee learns the ropes and is decreasingly depend on the franchisor's field representatives for support. Over the course of the following months the role of the field representative will focus more on quality control than on initial training and emotional handholding.

Once the franchisee has been through a complete business cycle (i.e., at least one year, perhaps two) he will be at ease with the business format involved and be focusing on expanding his customer base. He knows and understands the system and is looking for new opportunities. For the first several years this will be more than enough to keep him satisfied. As long as gross income is increasing and there is an expanding customer base, all will be well.

After several years, however, an established franchisee will begin to ask, "What have you done for me lately?" It is at this stage that the franchisee may try to change the system. This may or may not present a problem. For instance, in the McDonalds system it was franchisees who suggested and insisted on a breakfast menu. Many franchise systems reward franchisees for suggestions which are adopted by the system as a whole. If the franchisor's organization turns a deaf ear to such suggestions and adopts an authoritarian stance, franchisees are likely to become disgruntled. The franchisor's reaction must be to strengthen programs of communication and marketing assistance.

4. Termination, Expiration, Renewal

A franchise is not a permanent relationship. No marriage vows are taken. It is a relationship for a specified period of time. Ideally at the end of whatever that term is, the parties shake hands, wish each other well, and go their own way.

Franchisees depart, however, in a number of ways, only one of which is at the expiration of the contract term. Some franchises are terminated by mutual consent during the term of the contract. Others are terminated by one party or the other in a less than amicable setting. Still others are terminated because one party or the other has sold the underlying business. Each one of these scenarios involves a different set of potential problems including, but not limited to, cause, notice, opportunity to cure, and repurchase of inventory.

It is important to note that these problems exist for franchisor as well as franchisee. For instance, if the franchisee desires to sell his franchise to a willing buyer, the business acumen, personal characteristics, and financial stability of the new franchisee are as important to the franchisor as when the franchise was initially sold. Therefore, a franchisor must be involved in the selection or at least approval of the new owner.

If the franchise has ended by either termination or expiration, Noncompete Agreements may come into effect in order to protect valid trade secrets of the franchisor. Such agreements may pose a problem for a former franchisee who wishes to work utilizing the expertise he obviously acquired over the preceding years. Although such clauses are invalid in some states, elsewhere Noncompete Agreements serve a function in establishing at least a minimal sphere of protection for the franchisor for a limited period of time.

II. The role of the FTC in franchising.

The government's approach to the regulation of franchising is based on our approach to the regulation of securities, i.e., require that information be provided to enable one to make an informed business decision. The format of the required Disclosure Document is well designed, and the timing of delivery is appropriate.

Occasionally, it has been suggested that the FTC was really a "sleeping giant" since enforcement actions were few and far between. That seems to be changing now and in recent years substantial fines have been levied on major companies. The franchise industry itself does not complain extensively about the required Disclosure Documents. Although potentially expensive, preparation of the Disclosure Document can actually aid in the formulation of a thoughtful business plan and the structuring of a thorough infrastructure and superstructure for the franchising company.

III. Does the Federal Disclosure Rule provide sufficient information to enable the potential franchisee to make a reasonable decision?

Yes and no. The topics which are addressed are handled thoroughly enough for the purposes of the document. Because of substantial abuses in the area of earnings claims, the drafters decided to forbid such claims unless they were made in the context of a specified format. In order to make an earnings claim, Rule 436 required a reasonable basis for the numbers presented. This reasonable basis meant that profit figures from another store might not suffice if geographic and market conditions were not comparable. As a result, most franchisors decide to make no claims whatsoever. The franchisor states that he will not represent any level of profitability to prospective franchisees, and franchise salesman are trained and warned in this regard. This is ironic for it means that in order to comply with the law, the franchisor refuses to provide the one kind of information most desired by prospective franchisees - the answer to the simple question, "How much am I likely to make?"

American business people are an enterprising lot, however, and what seems to happen in reality is that although the Disclosure Document avoids any earnings claims and franchise sales people are instructed to make none, claims are made anyway. In the FTC's study of franchisees, the majority claimed to have received earnings claims in one form or another.

It may be that this is a problem which has no resolution. As with some other types of conduct which in their extreme are illegal, egregiously unrealistic earnings claims may be held to be fraudulent and perhaps the common law fraud approach to

controlling this issue is the best solution rather than another cumbersome regulatory process.

IV. What is the impact of the myriad of state regulation on franchisors? Would a uniform franchise law be beneficial?

The proliferation of franchise registration and disclosure laws has resulted in business expansion decisions which are totally unrelated to the business per se. The process of registering a franchise in New York or California can be very time-consuming and costly in legal fees while the resulting legal document protects prospective franchisees no more than the basic FTC document in nondisclosure states.

The problem is not just one of an initial expenditure, however. The states may not agree among themselves about the presentation of particular kinds of data which means that a franchisor ends up with multiple versions of the same Disclosure Document. And the multiple approaches must be continued indefinitely into the future since the documents must all be continually updated.

The Uniform State Law approach to this problem is only an apparent resolution. What is likely to happen is that an individual state will feel compelled to adopt some form of regulation, will use the Uniform State Law as a starting point, and then proceed to vary the legislation to accommodate local constituencies or to solve perceived industry problems. Franchises are almost inherently expansive, multi-state business organizations. The potential plethora of state laws constitutes a nonproductive barrier to such expansion in interstate commerce, while adding little to the franchisee's information.

In dealing with the question of preemption, the FTC Rule 436 adopts a standard of consistency. Only those laws which afford franchisees less protection than the federal rule are deemed inconsistent. Those "inconsistent" statutes are deemed preempted. The result is that most state and local laws stand, since they are more demanding than the Federal Rule.

The question is larger than the scope of information required for Disclosure Documents by the various statutes, however. The issue is also one of registration. At this time the federal law does not require registration of the document or the franchisor company. More than a dozen states do. Not only must the franchise document itself be prepared to comply with individual state statutes, but additional procedures are required involving the filling out of forms, the payment of fees, submission of the documents for approval, comment letters, and rewrites. None of which necessarily provides the prospective franchisee with any more protection. This means that we have increased the regulatory burden, multiplied legal fees, and complicated business expansion decisions all for a negligible gain.

V. The role of the Department of Commerce in compiling franchise statistics: do the statistics accurately reflect the franchise industry? If not how could they be improved? Is this data helpful in the franchise decision-making process? Should this activity be eliminated at the Department of Commerce?

The statistics provided by the Andrew Kostecka in his Franchising in the Economy have provided the core of reliable data for evaluating franchising trends for years. Since the statistics are compiled by a division of the United States Government, they have a credibility beyond any numbers presented by a trade organization such as the IFA or even by a university.

Not only is the credibility much greater, but the rate of return on any questionnaire sent out will most likely be much greater since it comes from the government. Therefore, it seems most regrettable that the OMB is considering eliminating an activity which costs so little and which helps so much in the understanding of a business phenomenon as significant as franchising.

The reliability of the statistics varies. First, some of the phenomena being measured are difficult to guage. For instance, one of the statistics over which we all preen is the very low rate of franchised businesses failures compared to other small businesses not affiliated with a franchise. There is a problem with our method of approaching this issue, however. In a number of franchise systems, if a franchisee is failing, the franchisor will assist him in selling his business, or perhaps the franchisor will buy the business back. From the standpoint of the franchisee, this could very well be considered a business failure, whereas from the standpoint of the Department of Commerce statistics it is not.

Secondly, because the Department of Commerce is distributing its survey to a select group, it may not be reaching all of the new, small franchisors. This may mean that the picture of franchising as presented to us is not totally accurate. The data summarized in the Department of Commerce's statistics is very helpful to the franchise industry, however, and to individual franchisors as they decide terms, royalty structures, or expansion patterns. The fact that the picture is not completely comprehensive does not mean that it would be better to have no picture at all.

VI. What future trends or legislative regulations are likely to emerge in franchising?

Given the development of the Uniform State Franchise Law, and the increasing amount of publicity on the franchising phenomonen, increased state legislation is likely. Since franchising regulation seems to parallel the philosophy behind securities regulation, it is likely that such statutes will involve registration and disclosure requirements. This trend will further complicate the business and legal processes involved in establishing or expanding a franchise network.

Secondly, the expansion of American franchisors into foreign countries will continue. This business trend has a very positive impact on the American economy since royalty payments return to the United States from other nations.

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LEGISLATIVE RECOMMENDATIONS

If I could recommend an ideal franchise regulation it would be a preemptive, federal statute requiring presale disclosure to prospective franchisees and filing of the Disclosure Document on the federal level. The Disclosure could be in substantially the same format as that required now by Federal Rule 436 or the Uniform Franchise Offering Circular along with a liberalized approach to earnings claims. The filing requirement would involve each company sending a copy of its revised Disclosure Document to the Department of Commerce at least annually or as often as it is revised. The data gathered from such documents might provide the Department of Commerce with a more comprehensive picture for Franchising in the Economy and could serve as a data base for prospective franchisees seeking to evaluate comparable business format franchises. This filing requirement, however, should not involve an evaluation on the part of the government as to the viability or profitability of the franchise in question.

The Department of Commerce Division which now follows franchising should continue to exist. It is this department which could serve as the repository for filed Disclosure Documents.

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Franchising is just one option in business expansion. It is no more a panacea for profitability than is incorporation, but the Franchising phenomenon is one of the most dynamic forces in American business today. As we look around, franchising is becoming America's business ambassador to the world.

August 4, 1988

REMARKS OF BOSTON ATTORNEY HAROLD BROWN BEFORE
THE SMALL BUSINESS COMMITTEE'S SUBCOMMITTEE ON
ANTITRUST, IMPACT OF DEREGULATION, AND PRIVATIZATION

Part I Regulating the Relationship

A. Covered Dealerships

The business format segment of the "franchise industry" has become a dominating force in the distribution of products and services. Fully defined, it probably exceeds fifty per cent of all such retail sales. Inexplicably, most franchise definitions fail to include many retail commercial activities such as the insurance industry where tens of thousands of independent agents provide the backbone of operations. Similarly, in the capital and wholesale markets, "authorized distributors" proliferate, but their activities and problems are simply ignored. For example, almost all insurance agents live with an appointment that is expressly terminable on thirty days' notice, or less, "with or without cause." Distributors of capital assets like machinery and equipment, are usually terminable "without cause" on thirty days' notice prior to any annual renewal date. The same standard usually applies to authorized agents who sell inventory items to retailers, like shoes, dresses, or paints.

The "coverage" of most federal and state franchise regulation is restricted to those who pay a specified cash sum for the franchise within an initial period, such as $500. within the first six months. That concept originated from

the pre-legislative era when California tried to provide protection for prospective franchisees by classifying a franchise as an "investment contract" protected by State "Blue Sky" laws. It was also a useful tool to fend off the objections of automobile manufacturers and other long established franchisors who argued that "deception" proliferated where franchisors "sold" franchises based on worthless schemes. Such factors are actually irrelevant when compared with the six or seven figure investment that a new representative must raise for capital equipment and inventory in order start the business. Their exclusion is therefore illogical and unfair.

B. Protection of the Dealer's Business

All of such "franchisees" have substantially identical problems with their franchisors, regardless of whether they "buy" the franchise. Manufacturers and suppliers face huge capital and management costs when they seek to expand as an "integrated" business. They turn to franchisees to share these investment costs and the attendant business risks. They do so without issuing any equity interest, without assuming any debt, and with no assurance of continuity "except for good cause." At the same time, however, they usually make sure that in case of termination "for any cause," they will retain the market developed by the franchisee. This is done through a wide variety of

techniques ranging from an option to control the business site, an option of first refusal in case of proposed sale, preemption of customer lists, protection of alleged "trade secrets," and post-term non-competition covenants. In these various ways, they deny the franchisee the benefits of the valuable goodwill developed in the local market among customers, suppliers, and employees.

There are potentially dire consequences. Very soon after the franchisee starts to operate, he is made acutely aware of these risks.[1] In order to avoid the "threat" of termination or the predictable challenge of renewal, he must always comply with every written and oral instruction from field supervisors, no matter how unreasonable, invalid, arbitrary, or whimsical they may be. If he does not fully cooperate, he will receive "demerits" for a "bad attitude". Among some prevalent abuses are the required purchase of inventory or equipment from the franchisor at prices well above those available in the market place for goods of equal or better quality. One major fast-food franchisor still gets eight cents a pound above the market price for the raw hamburger which the franchisees must buy from its wholly-owned subsidiary. In one fast-food system, the franchisor is trying to expand the scope of the in-term non-competition

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[1] See, e.g. the Supreme Court's comment in FTC v. Texaco, Inc. 393 U.S. 223 (1968), describing the compulsion arising from every gasoline service station dealer's acute knowledge of "which side his bread is buttered on." The same compulsion still continues in almost every franchise system.

covenant by precluding the franchisee's participation in a business that "competes" because it sells any "same or similar" products. Such a definition would preclude activity in any restaurant business that sells a cup of coffee or provides salt, pepper, and other condiments with its food. The legal cost to challenge such illegal and unfair restraints may involve very large sums of money. Because of the severe weakening of the Antitrust Laws, these practices may no longer constitute "anticompetitive" violations, but they are blatantly "unfair acts or practices."

Franchisee complaints are totally ignored until a major crisis and then the franchisor may simply reassign the offending supervisor or deny responsibility due to a lack of foreseeability.[2] When I publicly complained about alcoholism among the District and Zone Managers of one of the country's largest auto factories, dozens of those executives were soon consigned to "early retirement." While such retribution was prospectively remedial, the past carnage among the dealers was neither recognized nor compensated. It is hard to imagine the severity of an automobile dealer's living for many years under the control of a Zone Manager who daily became incoherent after his luncheon cocktails. Very few franchisors maintain a viable method of checking on the performance of their field supervisors who operate with

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[2] For an extreme case, see Dunkin' Donuts of America, Inc. v. Plocar, 431 N.E.2d 1176 (Ill. Ct. App. 1982) involving personal abuse by a field supervisor.

unlimited authority far from the seat of power.

When successful franchisees ultimately decide to sell their local business, they are often precluded from obtaining its fair market value. The transfer is usually subject to the franchisor's "reasonable" right of approval, but the franchisor retains unrestricted control over the renewal of the franchise. For example, in the seventeenth year of a twenty year franchise, the capitalized value of $200,000 in annual earnings will probably exceed $1 million. No sensible buyer will pay that price without reasonable assurance that the franchise will be renewed after the remaining three years of the twenty year term "except for good cause." The severity of this debility is enhanced by recognition of the franchisor's other controls over any proposed transfer, such as a contractual right of first refusal, the imposition of major remodeling needs, the restriction of previously granted territory, or simply by "suggesting" to the proposed buyer that the selling price is too high.

Such bias is further complicated by the fact that the franchisor is a direct competitor of the franchisee in the "capital asset" market. Franchisors continually engage in the sale of new franchises as well as in their repurchase or even reacquisition from a failing franchisee with little or no payment for the goodwill or property. After a few months of rehabilitation, the franchisor can resell the facility at its full "going" market value, reaping large profits which

are not shared with the former franchisee. Aside from the franchisor's control over the transfer or sale, sometimes requiring "reasonable" approval, the franchisor can depress the price or cause the loss of the sale simply by remaining silent on the issue of renewal. Of course, the franchisor may then sell a different unit to the same buyer or reacquire the unsuccessful site for little or nothing at the end of the term.[3]

Some franchisors are extremely bold in exercising their claim of an unconditional power to refuse to renew a franchise. In one of the most successful of all fast-food franchises, the entire real estate and restaurant are owned by the franchisor who then grants a twenty year lease and license to its franchisee. When there is a need for alterations or rebuilding of the facility, the franchisor will request the franchisee to "reinvest" (sic) in the realty in order to obtain some assurance of renewal at the end of the twenty year term. In so doing, the franchisor will acquire the complete title to the property improvements since it is the sole owner. In actual cases, the cost of such "improvements" may be in the range of $500,000. to

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[3] See Roseli, Inc. v. McDonald's Corp., CCH Bus. Franch. Guide, Para. 8870 (D. Neb. 1986), aff'd in unpublished opinion sub nom. Schupack v. McDonald's Corp., CCH Bus. Franch. Guide, Para. 8871 (8th Cir. 1987), where the franchisee lost all the value of his 20 year McDonald's franchise because he tried to negotiate a better deal and then failed to complete a sale before the last day of his 20 year term.

$1,000,000. thereby providing the franchisor with a huge windfall. It should be noted that the franchisor does not grant an unconditional right of renewal, so the "reinvesting" franchise may forfeit his entire capital cost. And if there is a renewal, it is the franchisor who will reap the windfall profit from the increased royalties resulting from the improved facility. In another leading fast-food system, after the franchisee was induced to buy the restaurant from the franchisor and to remodel the entire facility at a total cost of close to $1,000,000., the franchisor then granted a new franchise located less than two miles away on the interstate turnpike, thereby causing very severe impact by its encroachment. These cases are real. They are currently occurring. And they are abusive.

There has been only modest success in challenging these abuses through court process. Very few have succeeded in antitrust challenges, chiefly because this Administration has virtually dismantled the Antitrust Laws. It has done this through contrived "voodoo" economic theorizing, through abandonment of public prosecution, through amicus curiae briefs in behalf of violators, and through the exercise of Executive power over judicial appointments. Those policies have reached their highpoints in the Monsanto[4] and Sharp[5]

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[4] Monsanto Co. v. Spray-Rite Service Corp. 46 U.S. 752 (1984).

[5] Business Electronics Corp. v. Sharp Electronics Corp. 108 S.Ct. 1515 (1988).

cases. The House has already voted to override Monsanto, but it must now decide how to deal with Sharp.[6]

Franchisors and their powerful lobbies have usually succeeded in blocking bills to protect franchisees, particularly in State legislatures. This year they did so both in Nevada and in Massachusetts. In the latter, such a proposal has been unanimously approved every year by the joint Senate-House Committee on Commerce and Labor, but it has then been shelved. In Massachusetts, such legislation was enacted in 1971 in behalf of motor vehicle dealers (see Mass. G.L. c93B), and in behalf of gasoline service station dealers (see Mass. G.L. c93E). Before these bills were enacted, there had been dire predictions of their consequences. When they came up for passage, there was almost unanimous approval. And since their passage, there has been virtually no complaint over their application. In sustaining their validity, the Supreme Judicial Court has commented very favorably on several occasions.

Elsewhere, almost every major industrial-commercial State has enacted similar legislation. This includes such States as Connecticut, New Jersey, Delaware and Virginia. It stretches over the rest of the country to include Illinois, Indiana, Wisconsin, Michigan, Minnesota and Arkansas and the far west including Washington, Hawaii and California. In

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[6] See attached Appendix A for full discussion in my NYLJ Article, "Antitrust Counseling," June 23, 1988.

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1970, California was the first state to enact legislation requiring registration and presale disclosure to prospective franchisees. After 15 years of experience, California found that it was necessary to follow the lead of other important states by enacting legislation controlling the on-going relationship of the parties. In addition to the foregoing general legislation, many states have adopted identical franchisee protection in specific industries such as for dealers in agricultural equipment, beer and liquor dealers, newspapers, and office equipment, etc.

These state legislative precedents are persuasive. They reflect the fact that thousands of legislators from both major parties, with their particular Governor's approval, have found that there was a need to protect the business which the dealer had built up locally through his expenditure of time, money, and effort. Second, there is no reason why all franchisees should be deprived of the fair treatment given to millions of people in those States which have responded to the need. And demonstrably fair and honest franchisors have been able to function quite well and to flourish in those important States. Indeed, anyone can readily corroborate the need and the advantages of this legislation by communicating with officials in States that have acted. I particularly recommend that such verification be sought from the Governor, the Attorney General and legislative leaders in New Jersey, Illinois, California, and

across the nation where very extensive reports are available. All States should join the mainstream in bringing fairness to this vital and growing segment of commercial activity.

Part II Aspects of the Franchise Disclosure Rule

The Committee has indicated its interest in several aspects of federal and State pre-sale disclosure regulations. I would like to offer suggestions based upon my experiences from the representation of many franchisors, franchisees, and their associations.

1. Theoretically, there are many independent sets of State registration/disclosure regulations. In fact, however, there is a substantial degree of uniformity born of comity both among the different States and in their relation to the FTC Disclosure Rule. Historically, the California statute was the very first, enacted in 1971. Several States followed suit, generally seeking to achieve uniformity. By the time that the FTC Rule was adopted, effective in October, 1979, that regulation followed the same principle, preserving State regulations if they were equal or more protective. As a consequence, the preparation of disclosure materials has involved a substantially singular process after the franchisor has formulated its system. Individual variations exist, but they simply reflect minor differences that experienced representatives can readily

handle. They have done so for almost a decade, at minimal cost.

2. Through the on-going efforts of the North American Association of Securities Administrators (NASAA), there has been a steady review of the substance of the State disclosure regulations to improve their utility, to achieve uniformity, to encourage new entrants, and to simplify the legal requirements of compliance. Because their work has been based on actual, long-term experience in the largest States across the nation, their activity has been founded on direct experience in the field, rather than on abstractions. Their work is far less biased than can be found in the comments of franchisors, their associations, and their legal representatives. Further, NASAA has worked constructively, particularly in cooperation with the FTC staff devoted to franchising activity. This is best exemplified in their cooperation in modifying the policies and terms of the earnings disclosure provisions in section 19, as well as 20.[7]

It is noteworthy that the FTC activity is not well adapted to the task of rewriting its Pre-sale Disclosure Rule. By statute, it must proceed under elaborate hearings requirements, with witnesses, due process and

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[7] For extensive discussion, see H. Brown, "Franchise Forms" supplement to "Franchising: Realities and Remedies" (Journal Seminars-Press 1988).

extended legislative consideration, subject to court review. Significantly, it took almost a decade to produce the present disclosure rule. There does not appear to be any genuine interest in the repetition of this process, particularly where NASAA is providing a "better product," with sound empirical experience from many geographic areas.

By contrast, the "deductive" activity of the Uniform Law Commissioners for a national franchise law has proven to be a great disappointment with very little support from those States that have been closely involved in franchise regulation. Their product would sharply dilute the common law standard of "good faith and fair dealing" and it would create a useless administrative staff to handle pre-sale registration for those offering so-called "business opportunities." As defined, the latter include the vending machine and similar operators who offer the buyer almost nothing for their "front loading" sale of an opportunity. Most States already prohibit such operations, with some statutes specifying criminal penalties.

3. The so-called Uniform Franchise Offering Circular (UFOC) has provided a solid vehicle for franchisors. Newcomers can use the UFOC as a constant guide for their formulations, confident that honest completion of the application will provide substantial probability of

acceptance. Indeed, after approval in one or more States, there is virtual assurance of reciprocal approval by others. The real difficulties arise where the prospective franchisor has serious deficiencies in a dishonest record, in its lack of genuine experience, in limited finances, or in the disclosure of shortcomings. Uniformity of regulations will not overcome these difficulties. If the FTC is given preemptive control, it will not have the necessary staff to process the registrations. If it simply prescribes the disclosure requirements, the percentage of compliance will greatly diminish.

4. Perhaps the most serious concern should be for new putative franchisors who may have achieved success in their "direct" marketing of products or services. They are exposed to great risk when they seek to achieve entry into franchising through "packagers" who purport to provide all of the means to enter franchising. I have recently discussed this problem in "Guiding the Prospective Franchisor," my monthly New York Law Journal article, published July 20, 1988, a copy of which is attached as Appendix B. My conclusion is that franchisors should create their own franchise system, rather than copying the work of others either directly or through "packagers" who indirectly provide the same imitating process. In addition to the severe risk to

the prospective franchisor, their failure can produce havoc among their franchisees.

5. Current disclosure requirements do not provide adequate earnings data for prospective franchisees. The "triggering device" for the "earnings disclosure" requirements are fundamentally inadequate and they will remain so until affirmative disclosure is required in every case. The FTC purports to allow franchisors to avoid full earnings data unless there is some direct or indirect representation of such matters. It is almost certain that this formula simply produces "liars."

Many franchisors brazenly deny that they have given the prospective franchisee the most essential data required for a "life-time" investment decision. In fact, they cannot sell a deal unless they provide this data in some fashion. They must therefore resort to a wide variety of ruses. Some send the prospective franchisee to existing dealers where they can "get the low down." One prominent fast-food franchisor has the prospect devise his own set of "profit and loss" figures for "comparison" with those of the franchisor. The Manager of Franchise Marketing does not show his figures to the prospect, but orally declares the "differences" between the compared "line data." And if franchisors have literally avoided all "implications" of prospective sales, gross earnings, or net profits, then they will

have signed up the worst possible candidate for a franchise. Such a fool is probably doomed to failure.

6. There has been some claim that adequate pre-sale disclosure is all that is needed to eliminate abuses in the franchise relationship. "Disclosure" purports to provide a reasonable balance between the data that a prospective franchisee needs to know and the rights that the franchisor is willing to grant in order to make the sale of the franchise. Disclosure allegedly acts as a deterrent against misconduct and abuse.

After a decade of very extensive "disclosure" experience, California has finally adopted legislative regulation of the on-going franchise relationship. Its extensive studies proved that "disclosure" was not enough. It joined a dozen other major States that together encompass well over one-third of the nation's population. Those numbers are very significant. They are the States where most franchising exists, since large numbers of customers are so essential for successful retailing. Such widespread coverage of "conduct" also proves that legitimate franchisors are quite able to survive and to prosper where "fair" rules are enacted to protect the franchisee as the weaker partner in a long-term business venture.

7. There is a growing recognition that "declared policy" statements of the franchisor will also supersede the

cleverly drafted, one-sided franchise agreement. The prospective franchisee places his faith and trust in the franchisor only to discover that he erred. The priority of declared policy will prevail because of its basic fairness. In one of my recent columns, I addressed the intriguing legal concepts that assure this course of the law.[8] Perhaps the firmest ground for reliance on "policy" is the legal requirement that a franchisor must disclose to a prospective franchisee all the information that is reasonably necessary for a serious business investment like the purchase of a franchise.[9]

8. There is no doubt that the FTC cannot adequately enforce compliance with its own disclosure rule. It does not have enough staff, funds, or desire of accomplishment. In fact, there are already enough available laws to enable the FTC to accomplish the task, as discussed in my NYLJ article "The Numbers Game."[10] These powers are sparingly used.

When the FTC published its Rule, it called for

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[8] See attached Appendix C, my N.Y.L.J. article "Policy Versus Contract," published April 26, 1988.

[9] See Bailey Employment Systems Co. v. Hahn, 655 F.2d 473 (2d Cir. 1981), on remand, 545 F.Supp. 62 (D. Con. 1982), aff'd in an unpublished per curiam opinion by the Second Circuit, Feb. 17, 1983, in which the district court applied the Connecticut Unfair Trade Practices Act.

[10] See Appendix D, H. Brown, "The Numbers Game," NYLJ, February 1, 1988.

"private enforcement." That effort has been almost universally rejected as an implied "private" cause of action. Consequently, the "little" FTC Acts have become the principal vehicle for such "private" enforcement as a classical aid to public action.[11] Unfortunately, such statutes do not exist in most States, leaving a distinct imbalance in franchisee access to this vital tool. The correct resolution lies in Congressional approval of a private cause of action. So far, there has been inadequate support. Further, it may prove undesirable if it produces a hobbled private action such as those provided by Congress for auto dealers (15 U.S.C. 1221-1225) and gasoline service station operators (Petroleum Marketing Practices Act, 15 U.S.C. 2801).

By contrast, although State pre-sale disclosure statutes are quite varied and contain many inadequacies, almost all provide some form of private enforcement. There is strong reason to believe that the move to obtain a "national" disclosure statute, may be a pretext

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11 (See Bailey Employment Systems Co., supra. n.9. There is still some judicial reticence. see, e.g. Fickling v. Burger King corp., 54 (BNA) ATRR 675 (4th Cir. unpublished per curiam opinion) (dismissing unfair trade practices claim under North Carolina "Little FTC" Act where there was no breach of contract and "therefore no fraudulent, unfair or deceptive act" by Burger King). This is clearly erroneous under numerous FTC decisions that universally preclude "contracts" as justification for "unfair or deceptive acts or practices." See Commonwealth v. DeCotis, 316 N.E.2d 748 (Mass. 1974) (the substantial contractual charge for "little or no services," does not justify an "unfair practice;" it only shows the extent to which the licensee is at a disadvantage).

for repeal of all State statutes, in the same way that PMPA preempted all State "termination" laws protecting gasoline service station dealers. The alternative kind of disaster is found in the federal Auto Dealers' "Day In Court" Act that provides little more than an "airing" since "good faith" is statutorily defined to require actual "coercion." No court has ever defined "good faith" in such a ridiculous manner.

Part III. The Prospects for Franchising

The rapid and pervasive development of franchising cannot be stopped because it is fundamentally a very sound choice for the commercial marketing of goods and services. It can provide great rewards for the legitimate franchisor while assisting small business persons to enter the market as their "own boss."

Periodically, franchisors have tried to eliminate or cripple federal and state regulation. Their expressed threat is that franchising cannot live in a "regulated" world. They expressly predict their withdrawal from States that "over-regulate." Alternatively they declare that "forward integration" will wipe out franchising. These predictions have not occurred and they have never been rooted in fact.

To the contrary, many enlightened franchisors have voluntarily adopted the identical standards and practices mandated by State legislation. Many of those franchisors

have flourished beyond their fondest imagination. Indeed, the day appears near when all franchisors will "get the message." They will find that a body of vital franchisees provides the greatest assurance of their own success.

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FRANCHISING

HAROLD BROWN

Antitrust Counseling

FOR OVER A DECADE, it has been very difficult to obtain a judicial finding for franchisees under the antitrust laws and to retain it on appeal. The trend originated in the "rule of reason" standard mandated by the U.S. Supreme Court in *Sylvania* for all "vertical restraints" except resale price maintenance.[1] It has reached its climax in the two Supreme Court rulings of *Monsanto*[2] and *Sharp*.[3] The challenge has not been finally resolved, and Congress has already taken serious action to reverse *Monsanto*, with possible effect on *Sharp*.[4] In the process, confusion has unexpectedly been increased by the Court's logic, while no one can be sure of the impact from a new administration. The conflict is definitely not academic, since current business activity may have to be judged in later litigation under a completely different climate.

To the uninitiated, that introduction may appear to be meaningless, but it can be simplified. The overall fact is that when it took office in 1981, the administration publicly declared its intention to dismantle the antitrust laws. It has used every means to accomplish its goal, including a nonfunctional prosecutor in the Antitrust Division of the Department of Justice. Rather than pursuing violators or even remaining passive, it has vigorously joined in the defense of violators at the appellate level and issued strongly criticized "guidelines" that virtually sanctify all "vertical" restraints.

The campaign has been institutionally supported by the Executive's appointment of almost 50 percent of the sitting federal judiciary, including the Supreme Court, each of whose members now sponsor revolutionary conservative policies. The onslaught on "pro-competitive" philosophy was grounded in a singular "economic" philosophy that has been repeatedly criticized as the counterpart of the "voodoo" principles of this administration's "supply-side" economics.

In deceptively attractive language, the Executive Branch declared that the only legitimate goals of antitrust policy are "efficiency" and "consumer protection." The definitions of these phrases were then tortured beyond recognition. According to the Antitrust Division, "consumer protection" is to be judged solely by what "suppliers" may decide is in the best interest of their customers. That ideal is guided by those "efficiencies" that manufacturers select as the best way to market their goods and services. And any dealer who violates such a program can lose his business.

The Nature of Efficiency

Under such precepts, consumers are precluded from saving money by purchasing from a discounter who openly competes in the marketplace. The discounting dealer is defamed as a "free rider" who "may" purloin benefits of the "free services" prescribed by the factory, without paying his "fair share." This deceptive logic is colloquially supported by the statement that there isn't any such thing as a "free lunch."

As for the factory's "efficiencies," these do not refer to practices that are most productive in reducing manufacturing or distribution costs that may then be passed on to the consumer in real savings. The "efficiency" refers to the factory's marketing plan to maximize its sales and its net profits, rather than those of the dealer who is compelled to provide them "free." The Administration asserts that this is "best for the consumer" in spite of its impact on dealers and the absence of any assurance or history that savings ever "filter down" to the consumer.

Properly viewed, this system is a rehashed version of the rationalization that was unanimously condemned by both political parties in 1976 when the infamous "fair trade laws" were repealed. Those statutes allowed makers of trademarked goods to set the re-sale price and in some states, even to bind non-signatories to such price lists.

Congressional investigation proved that those statutes actually increased the retail prices paid by consumers 35 percent to 70 percent. The fixed or minimum prices tolerated for trademarked goods under the "fair trade laws" were theoretically justified in order to pay for the "free" services prescribed by the producers. The facts proved that it was not true. Nothing has changed since, then. The administration's apologists respond that such "savings" are "possible" and that in a free economy it is not up to the government to verify whether it is true.

As frequently noted, the *GTE Sylvania* case consigned almost all vertical restraint cases to the "rule of reason," as distinguished from the "per se" rule that precluded the need for exhaustive "market" analysis and virtually prohibited any justification for the anticompetitive practice. The simplification of trials also made it possible for "private parties" to aid in the prosecution of the laws and eased the judicial task of evaluation.

By consigning valuation to the "rule of reason," almost all private litigation became too expensive and too risky. Former Judge Robert Bork went to the ultimate extreme by decrying the ability of any judge to compare "procompetitive" benefits with "anticompetitive" consequences and therefore ruled out all such judicial functions so long as any "possible" justification could be projected, rather than "proven" in fact.[5]

As case after case failed at trial or appeal, the singular "per se" exception was reserved for "vertical" price fixing, or "resale price maintenance." Before *Monsanto* and then *Sharp*, the courts continued to chop away at established corollaries. While "vertical" restraints clearly reflected the "supplier-retailer" relationship, as distinguished from the "horizontal" label for competitors at the same level, the courts blurred this distinction. Competing dealers were "horizontal" competitors, but the *per se* label was removed where the supplier either originated or adopted the practice as its own or was the party primarily benefited. Judge Bork took the opposite extreme when he classified competing dealers as "horizontal." He then eliminated all possible violations by declaring that "intrabrand" competitors were "economically integrated by contract" into a single entity and were therefore incapable of entering into the "contract, combination, or conspiracy" proscribed in §1 of the Antitrust Laws.[6]

In *Monsanto*, the Supreme Court sought to protect and enhance "non-price" restraints by making it more difficult to infer such a "pricing conspiracy." The Court declared that "there must be evidence that tends to exclude the possibility of independent action by the manufacturer" and that "reasonably tends to prove that the manufacturer and others had a conscious commitment to a common scheme designed to achieve an unlawful purpose."[7] The Court sustained the sufficiency of such evidence in *Monsanto*, even though it appeared to be somewhat problematic.

In *Sharp*, there was no doubt that the *Monsanto* test was strongly satisfied. When the discounting dealer persisted in its practices, the competing distributor expressly threatened to cease its factory representation unless the latter terminated the discounter. The factory complied. This "combination" between the manufacturer and the complaining dealer was nonetheless rejected by the Court's majority on the ground that the factory had not entered into an express agreement with the complaining dealer "to charge specific prices or to maintain them at a prescribed level."

As the dissent stated, there is no doubt that the parties' conduct was a prohibited "restraint" and that the "combination" was more than sufficient. The evidence was clear; the jury specifically found the necessary facts; neither the trial nor circuit courts questioned the propriety of the jury's finding; and under the applicable "per se" evaluation, the "quite plausible" justification extrapolated by the majority was neither founded in proven fact nor judicially acceptable as a legal excuse.

None of these jury conclusions were challenged by the Supreme Court's majority. Instead, the latter opined that future jury fact finders might be "unable" to distinguish between "truthful and pretextual defenses" and that the beleaguered manufacturer would therefore be unwilling "to expose itself to the highly plausible (*sic*) claim that its

real motivation was to terminate a price-cutter."

Since this jury expressly found that that was the motive in *Sharp* and no one questioned that finding, there is no way to justify the Supreme Court's logic. The minority correctly concluded that there were no procompetitive benefits, "the sole purpose of the agreement between (the factory) and (the competing dealer) was to eliminate competition at the (dealer) level." It quoted former Judge Bork's "Antitrust Paradox" (at 334) that this was therefore a "naked restraint" that should be held *per se* illegal.

Changing Climate

In reaching this conclusion, the majority opinion sought umbrage in a whole string of prior Supreme Court decisions that have been disparaged as unreliable by administration apologists as well as by their principal spokesman, former Judge Bork. For example, in *Rothery*, Judge Bork declared that the *Topco* case[6] had been effectively reversed; in *Sharp*, Justice Scalia strongly relied on that decision to demonstrate the difference between a "vertical" and a "horizontal" agreement to divide territories in which the latter "had to be * * * *per se* illegal."

Similarly, he strongly reiterated the *per se* violation of a horizontal boycott in *Klor's*[7] and of horizontal dealer price-cutting in *General Motors*,[8] all of which had been characterized by Judge Bork as "out-dated" and "no longer valid."

The very essence of *Sharp* was its reliance on the "vertical" resale price maintenance in *Albrecht*[9] where it declared there had been two specific pricing agreements by the publisher and third persons. The first was where "the newspaper hired a third party to solicit customers away from the non-complying retailer" and where the solicitor "was aware that the aim of the solicitation" was to force a lowering of prices by the non-complying dealer.

Second, the paper engaged another retail dealer who "undertook to deliver (papers) at the suggested price." This "rehabilitation" of the *Albrecht* case went to the very heart of the *Sharp* formulation. Almost every administration spokesperson had long ago consigned *Albrecht* into limbo as supporting "minimum" rather than "maximum" prices, to the "detriment" of the consumer.

Within two weeks after *Sharp*, the Supreme Court denied review in several antitrust cases, chiefly involving resale price maintenance. While the denial of certiorari does not imply Supreme Court approval, even the circuit court rulings are informative. In a separate petition in the *Sharp* case,[12] the Supreme Court declined the factory's request that it grant review in order to eliminate the *per se* illegality standard for resale price maintenance.

In *Garment District, Inc.*,[13] the denial of appeal related to a Fourth Circuit ruling that while a 200-outlet retailer threatened to stop buying from the factory unless the latter terminated the discounting dealer, the factory's motive was not price related but "merely seeking to avoid the loss of a large customer." In a case[14] much closer to *Sharp*, the Eighth Circuit concluded that the jury could not be given the task of distinguishing whether the admitted agreement of the factory and the complaining furniture retailer was "non-price" motivated (i.e. failure to advertise and to service its products) or "merely pretextual," (i.e. a lie). In *Isaksen*,[15] the non-complying dealer was forced to raise its prices by a pricing conspiracy, but it was not allowed to measure its damages from lost profits due to its surrender of "free rider" status. In *Mercedes* involving a "free rider" context, the Supreme Court declined to review a tying violation[16] in which the dealers' purchase of Mercedes Benz automobiles was made contingent on their agreement to buy all replacement parts from the factory. The factory distributor claimed that the requirement was reasonably necessary to meet consumer expectancies, to avoid warranty "free-riding," and to assist in the enforcement of quality standards.

This quagmire of "pricing" and other rulings may be cleared by Congress in the proposed "Freedom from Vertical Price Fixing Act of 1987."[17] The current version of the bill would allow an inference of price-fixing to be drawn from a termination that is "in response" to a price-related communication, as had been found in *Monsanto*. While the current administration opposes the measure, the bill has obtained strong backing from State Attorneys General, from the National Association of Discount Stores and from consumer associations. It is juridically supported by many who strongly believe that the antitrust laws provide a genuine Magna Carta of protection for consumers and for small enterprises that want to compete in the marketplace without artificial restraints imposed by manufacturers or suppliers.

Finally, discount retail stores are firmly established as a way of life in American society. Tens of millions of ordinary consumers are unwilling to surrender their access to legitimate sellers who are anxious to sell "superior products at bargain prices." Consumers refuse to be duped by compulsory "free services," a synonym for "loaded extras." They are an excuse for higher, not lower, prices, especially since the value of such a "package deal" is usually problematic.

By now, American manufacturers have regretfully discovered that when they oversell such high-priced products "loaded with undesired extras," there will always be a national or a foreign supplier to sell a "stripped" model at bargain prices. It took 10 years for American auto factories to learn this lesson.

It is wrong for the government to rig the market to protect those suppliers who "load" their merchandise with expensive "extras" and then complain against "free riders." Such ill-advised suppliers have persuaded the current administration and its carefully chosen court appointees to subsidize their "loading" tactics by contrived manipulation of long-established legal precedents. The antitrust laws were designed to prohibit all such artificial interferences with the market place.

(1) *Continental T.V. Inc. v. GTE Sylvania, Inc.*, 443 U.S. 36 (1977).

(2) *Monsanto Co. v. Spray-Rite Service Corp.*, 46 U.S. 752 (1984).

(3) *Business Electronics Corp. v. Sharp Electronics Corp.*, 56 USLW 4387 (May 2, 1988), 54 (BNA) ATRR 787, — S.Ct. — (1988).

(4) See H.R. 585 (100th Cong., 2d Session), dubbed the "Freedom from Vertical Price Fixing Act of 1987," passed by the House of Nov. 9, 1987, and pending before the Senate Judiciary Committee.

(5) *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F. 2d 210 (CA DC 1986), cert. denied, 107 S.Ct. 880 (1987). See H. Brown, "Bork on Distribution," NYLJ, Sept. 23, 1987.

(6) *Ibid.* see 15 USC 1.

(7) Supra, n.2.

(8) *United States v. Topco Assoc. Inc.*, 405 U.S. 596, 608 (1972).

(9) *Klor's Inc. v. Broadway — Hale Stores, Inc.*, 359 U.S. 207 (1959).

(10) *U.S. v. General Motors Corp.*, 384 U.S. 127 (1966).

(11) *Albrecht v. The Herald Co.*, 390 U.S. 145 (1968).

(12) *Sharp Electronics Corp. v. Business Electronics Corp.*, S.Ct. Dkt. No. 85-2094, cert. denied, — S.Ct. — (1988).

(13) *Garment District, Inc. v. Belk Stores Services, Inc.*, 799 F. 2d 905 (4th Cir.) cert. denied, (S.Ct. Dkt. No. 86-794) — S.Ct. — (1986).

(14) *McCabe's Furniture, Inc. v. La-Z-Boy Chair Co.*, 798 F. 2d 323 (8th Cir.), cert. denied, S.Ct. Dkt. No. 86-1101, — S.Ct. — (1988).

(15) *Isaksen v. Vermont Castings, Inc.*, 825 F. 2d 1158 (7th Cir.), cert. denied, S.Ct. Dkt. No. 87-610, — S.Ct. — (1988).

(16) *Mercedes Benz of North America, Inc. v. Metro Warehouse, Inc.*, 828 F. 2d 1033 (4th Cir.), cert. denied, S.Ct. Dkt. No. 87-1560, — S.Ct. — (1988).

(17) See n.4, supra.

Harold Brown *is senior partner of the Law Offices of Harold Brown in Boston. He is the author of a revised edition of "Franchising: Realities and Remedies" published by the Law Journal Press.*

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FRANCHISING

HAROLD BROWN

Guiding the Prospective Franchisor

FOR CLOSE TO two decades, franchisees and prospective franchisees have been protected by federal and state legislatures, administrative agencies and the courts. Almost no attention has been directed to the plight of new franchisors, especially those of moderate size.[1] There are thousands of these, most of whom either want to start a new business through franchising or already have a going business that they want to transmute into a franchise system.

Such enterprises may have developed a viable business with multiple units showing steady — but not meteoric — growth in sales and net profits. At that stage, they are likely to turn to franchising as means of more rapid expansion, primarily to obtain the dealers' capital contributions as well as entrepreneurial skills. Alternatively, the franchisor may attract candidates avid to share his or her success under tutelage.

The sought-after franchisor may then seek guidance from his attorney, accountant or advertising agency. Discovering that such professionals are usually inadequate, the franchisor may turn to the professional "packagers" or "brokers" that have popped up across the land. The latter are eager to provide the new franchisor "every tool for passage to the promised land." Such a simple solution is loaded with serious risks. The head of one such packager was quoted as saying, "I wouldn't recommend getting involved with 90 percent of the franchise brokers I've seen."[2] There are alternatives.

Book by Chicago Lawyers

Two Chicago lawyers, N.D. Axelrad and L.G. Rudnick, have produced a *Planning and Sales Compliance Guide for Franchising*,[3] with extensive detailing of the issues, the processes and the substance involved in becoming a franchisor. The study is an excellent source for would-be franchisors before they have actually decided how to proceed. They will find that franchising is a superb distribution procedure but that it is also a very complex, multi-party arrangement that takes considerable time and substantial funds, plus serious responsibilities. If they then go ahead, they will have a solid foundation on which to decide whether to develop the franchise system within their own business structure or to farm out the entire effort to a packager or others. Legitimate "brokers" can also benefit from studying the book.

Part A of the book is devoted to the business aspects of setting up a franchise, divided into nine chapters of exposition and a four-page exhibit of the "essential elements of organizing and implementing a franchise program." These chapters cover an overview of franchising, self-analysis, planning, the nature of the relationship, the costs, relevant laws, alternatives to franchising and assistance in developing a franchise program. These topics are vital, but the reader is cautioned against the belief that the text contains all the answers. For example, the 15-page discussion of "relevant laws" in Chapter VI can hardly be more than descriptive.[4]

Part B "explores the various aspects of state and federal regulation of the franchise sales programs." It includes chapters on registration, disclosure, negotiations, earnings claims, sanctions and a compliance program. These nine chapters are supplemented by 15 exhibits related to these regulations and how to operate within their limits. The materials have been assembled with the benefit of many years of in-house experience by one author and equally extensive activity by the other in an independent law practice that includes close participation in one of the leading franchisor associations.

This is the first time that this kind of practical advice has become available in such accessible form. Theoretically, it would take only a few days to read this 255-page volume. In actuality, though, each chapter discusses an almost endless series of crucial issues, with only the possibility of superficial answers to specific questions.

The reason for this shortcoming is the inherent nature of the problems. Many of the problems would individually merit an entire chapter of full discussion. Lacking that opportunity, the authors continually suggest great care and extended discussion with experts in each area. The book is a superb primer for an entire course of instruction or to draw managerial attention to the endless concerns in formulating and commencing a complex distribution system.

One immediate benefit is the negative impact of the book. Prospective franchisors are compelled to recognize the substantial time, effort and capital needed to establish a successful franchise enterprise. That picture is quite different from the one envisioned by the slick promoter looking for huge cash flow with minimal effort.

The Packager

In spite of those precautions, a moderately successful business person may nonetheless plunge into franchising. The correct plan requires the full-time assignment of experienced executives within the company. They are the only ones with the necessary "knowhow" to construct a valid franchise system. To avoid burdening an already busy staff, the company may turn to the packager, a company that proclaims its ability to put the whole thing together with a modicum of waste of expensive talent and time.

The packager may offer to provide a franchise agreement and a pre-sale disclosure document to assemble a Confidential Manual to guide the selection, preparation and use of marketing materials. It may even offer assistance in selling franchises; in supervising the audit of franchisees to assure compliance, particularly in maintaining and submitting records, and in assuring royalty payments. These functions would supposedly complement the company's established success in marketing the particular products and services, including capital facilities, merchandising, advertising, inventory controls, recordkeeping and selling techniques.

The book cogently proves that such a simple formula is unlikely to succeed because it ignores dozens of crucial issues that must be analyzed and carefully resolved to assure a reasonable chance of success. The franchisees are intensely dependent on the continued long-term success of their franchisor. They may survive in spite of the supplier's collapse, but they will have had to do so without any of the important benefits derived from a vibrant franchise system.

These benefits include name recognition, accepted products or services, jointly sponsored advertising, uniform standards, approved suppliers and, possibly, joint purchasing programs for economies in price, warehousing

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and delivery, research and development and continued adaptation of the system to marketing needs. Simply put, the family of franchisees can obtain very substantial benefits from the well-operated franchisor.

As with many aspects of franchising, there can be serious shortcomings in the packager. There are no established formats for "pre-sale disclosure" by such a packager to the prospective franchisor interested in such services. There is no realistic way to know the company and its executives, their track record in setting up successful franchisors, their litigation and failure record, the originality of their written work, the efficacy of their proposals or the hidden problems created by their activities. If matters go poorly, it will be virtually impossible to distinguish the cause of failure, whether it is the performance of the packager or deficiencies in the "follow-through" of the inexperienced franchisor. The packager may well have failed or disappeared, leaving the franchisor with huge losses and an uncollectible judgment.[5]

Steep Prices

The prices charged by some packagers can be appalling. Further, there are virtually no standards by which to evaluate the worth of their services or their pricing practices. A few illustrations may help:

1. In one case, an initial retainer of $100,000 was demanded. When the franchisor said he was unable to deliver such a liquid sum, the packager promptly arranged a bank loan for the franchisor in the full amount. The proceeds were then "paid" to the packager who secretly guaranteed the loan by a redeposit of the entire proceeds. As the franchisor gradually paid off the bank loan, the bank released the net payments to the packager. In addition to the gross deception, this factual pattern almost guaranteed that neither the packager nor the putative franchisor would be able to provide the substantial funds needed for a new franchise system.

2. In return for a supposedly "reduced" hourly rate for services in setting up the franchise system, the packager obtained a one-third equity interest in the franchisor's corporation. The rate was in fact steep for the actual services, especially since the franchise agreement, disclosure and other materials were essentially boilerplate forms with slight adaptations to achieve the appearance of "custom design."

3. The packager acted as a director of operations for the franchisor, ordering elaborate production by each of the specialists engaged to help formulate the franchise. These included experts in architecture, signs, furnishings and fixtures, equipment, advertising, accounting, marketing and law. While such services may be valid, the franchisor was forced to call a complete halt when the intermediate cost of these outside services ran into seven figures. In addition to the current hourly charges, the packager also obtained a contingent fee for each franchise that might be sold, even though sales were produced by others. (There were also unexpected high costs for legal services in the subsequent litigation.)

Aside from these highly questionable practices, there is a fundamental flaw in such farming out of these vital franchisor responsibilities. It is the franchisor's obligation to formulate and develop the system. In reality it is highly improbable that a franchisor can transfer its knowhow and experience to an outside packager for implementation and transmission to the franchisees. If the packager does in fact perform valid functions at fair prices, it cannot adequately re-transmit to the franchisor's managers the full benefit of the research, analysis and implementation that went into the complicated formulations. At best, the packager can only try to recapitulate its decisions and results, with no access to the elements of fine-tuning.

Avoiding Disservice

There is only one way to avoid this disservice to the franchisor and the franchisees. The franchisor must carry the principal burden of creating the franchise system. The *Franchising* volume is ideal for guiding the franchisor's executives in this vital procedure. It can help the franchisor understand the elements of franchising. And it will enhance the franchisees' relations with the company over an extended period.

There is also a flip side to this analysis. Where franchisees do not enjoy the professed benefits of their particular store, one of the first things to look at is the way the franchise system was put together. Where the franchisor has simply "contracted out" the whole formulation, the franchisor should be required to disclose its abandonment of its basic duties. The same disclosure standard applies where a franchisor has deviously acquired all the documentation of a successful franchisor and then cosmetically altered a few elements to gain the false appearance of originality.

Franchising provides a laundry list of do's and don't's compiled by highly experienced professionals. Counsel for franchisees should carefully ask clients how the hard questions were handled by the particular franchisor, the extent to which appropriate disclosure should have been made and the degree to which damages were related to specific shortcomings.

While relating how a franchise system should be formulated, this book has also made a major contribution to the resolution of disputes between franchisors and franchisees. The authors have fashioned a path to guide franchisors. The work has also exemplified almost every aspect of the "duty of good faith and fair dealing" that controls this imbalanced, long-term relationship in which the parties have a joint economic stake.

(1) See, J. McNair, "The Artful Dodger," *Venture Magazine*, July 1988, p. 45, recounting the escapades of Stephen Eisenberg in bringing numerous franchisors to the marketplace only to end up with an endless string of disgruntled clients with uncollectible judgments against him.

(2) See, M. Hartnett, "Telling the Best from the Rest," *Venture Magazine*, July 1988, at p. 48.

(3) N.D. Axelrad and L.G. Rudnick, "Franchising," (CCH 1987), 255 pages.

(4) For more extended legal discusson, see my book, "Franchising: Realities and Remedies," (*Law Journal Press*, Rev. Ed. 1988), containing over 1,500 pages, including a current "Forms" supplement.

(5) See article in n.1 reporting the extensive losses of many franchisors who dealt with a single "packager."

Harold Brown *is senior partner of the Law Offices of Harold Brown in Boston. He is the author of a revised edition of "Franchising: Realities and Remedies" published by the Law Journal Press.*

Policy vs. Contract

Franchise law involves the conflict between a franchisor's declared policy and the terms of the franchise agreement.

Most franchise agreements contain a variety of covenants intended to preclude the use of any extraneous promises, whether oral or written. Such clauses include the standard "integration" provision declaring that the agreement contains all of the understanding and that all representations and promises which preceded the execution of the agreement have been incorporated. It further rejects any reliance on such statements. And it may declare that no alteration or amendment will be effective unless contained in a writing signed by a duly authorized official. Overcoming such "boilerplate" clause can be a real challenge.

The conflict is illustrated where a dealer's agreement expressly provides that either party may terminate the contract on 30 days' notice. Such termination clauses can include a wide variety of time limits, none of which requires proof of "good cause," "good faith," or "notice with an opportunity to cure." The unfairness of such provisions has been widely recognized by state legislation that prohibits termination, as well as failure to renew or to approve a reasonable transfer, except for provable "good cause."[1] Such enactments apply to existing franchises so long as legislative intent can be inferred.[2] In addition, there are other statutory or common law defenses, ranging from the U.S. Bankruptcy Code to standard defenses like unconscionability, illegal penalty, mutual mistake, etc.

Contradictory Terms

The harsh contract terms may be contradicted by oral or written statements that have been made by an authorized company representative. Before signing such a franchise contract, the prospective franchisee is likely to raise strong objections to the availability of arbitrary "termination without cause," especially where the new dealer would have to invest considerable money and energy in order to commence and sustain operations. Similar protest may occur where the tradename, the product or the services are new in the territory, requiring heavy longterm investment in advertising and goodwill promotion.

In one prominent case, an appellate judge cogently described the improbability of the situation, declaring:

"the price paid for some of the (newsdealers) routes was between $200,000 and $300,000. No one in his right mind would purchase anything for such a large sum believing that his right to keep and work and continue to profit from the property could be terminated upon four days' notice. Nothing could be more obvious than that the carriers, in purchasing the routes and in devoting their lives and fortunes to build their businesses, acted in reliance on the company's previous owners' and managers' explicit and implicit representations and acts giving assurance that the contractual relationship was a lasting one and not subject to unilateral termination without cause."[3]

Notably, the estoppel was held binding against the successor publisher who had bought the newspaper.

Investments Costs

The investment in a franchise can readily exceed the quoted figures. An existing fast-food franchise is often sold for $500,000 to $800,000, based on its "going business" valuation. A new franchise may cost from $25,000 to $50,000, for the license, but the capital investment for plant and equipment can reach $1 million or more, while inventory and developmental costs can easily exceed another $1 million.

In a leading fast-food system where the franchisor owns the improved real estate, it often urges the franchisee to "reinvest" close to a million dollars in structural improvements as a precondition to obtaining renewal. By law, the franchisor retains title to the real-estate additions. In the absence of reasonable assurance of continuity, the franchisee may lose his or her entire investment unless there is a renewal. The franchisee is literally required to place him or herself at the franchisor's absolute mercy unless a "policy" assurance can be obtained.

When a prospective franchisee seeks security for the future of the franchise, a reputable businessperson is likely to say that he or she has no authority to alter the written agreement, but that the contract doesn't explain how the situation really works. This individual will assert the factory's reputability for "fair dealing," plus its genuine interest in helping the dealer to succeed. The person's explanation will usually go on to describe how the factory makes it a practice to police the dealer's performance, to consult with him or her whenever there is a shortcoming, to try to work out a plan to improve the situation, to work with the dealer, and finally to take definitive action only when the proposed remedy has failed. If requested, the executive will send a written confirmation of such company policy after the execution of the franchise agreement.

The format of these "policy" declarations may vary. For example, most of the major insurance companies have repeatedly declared that they would never resort to their unconditional contractual right to terminate a "general agent" on 30 days' notice unless the agent was plainly guilty of mishandling premiums, of making false reports, or of comparable major defalcations. When termination is inevitable, they declare they will provide enough time so that the general agent can obtain another insurance carrier. Factories have made similar declarations to their "authorized" distributors, many of whom operate under annual agreements that can be terminated on 30 days' notice prior to any annual anniversary. It would be incongruous for the factories not to give these assurances, since their own success is dependent on a healthy dealer network.

Dealer Favored

There is a growing base of court decisions that supports these "policy" declarations in spite of a written agreement. These cases clearly favor the dealer's position on the basis of fairness in the particular factual circumstances. They have found substantial support from a variety of sources, buttressed by the Restatements of Law, both in contract and in tort.

Some form of estoppel may occur where the representation of policy devolves from the franchisor's "express statements, from actual conduct, or from silence if there is a legal duty to speak."[4] In *Miskimen*, the newspaper publisher had written agreements with each newsdealer, giving it the right to terminate on four to 30 days' notice. In fact, it had never done so except when it elected to increase its wholesale prices. It would then terminate all agreements and execute new ones with the current price schedule. For years, the dealers had bought and sold their territories for substantial prices, with notice to the publisher and its signing a new agreement, perhaps after making sure that the purchaser paid the bills. This data, corroborated by other statements and conduct, was held enough to constitute "representations," with reasonably anticipated reliance by the dealers. The court concluded that the publisher was therefore estopped to exercise its contractual termination privilege.[5]

In the *Straup* case, a Pennsylvania appellate court went further to find enforceable contractual rights based on "promissory equitable estoppel."[6] The newsdealers had no written agreement. The facts were quite similar to those in *Miskimen*. In addition to the promissory representation, it is necessary to show reliance that was reasonably anticipated and that justice requires protection. It is, however, inadequate to show "reliance" in the form of consideration that was contractually required. Allegations of promissory equitable estoppel were also used in *Highland News v. The Hearst Corp.*,[7] settled immediately prior to trial.

It is, of course, quite normal for marketing executives, distribution managers, and field supervisors to make hundreds of promissory representations of "fair treatment" both before and after the inception of the relationship, designed to encourage their dealers to utilize maximum effort to attain high performance. And the spoken or unspoken word will always be the equivalent of stating: "Don't worry. This dealership will always be yours so long as you're doing a good job, paying your bills, and promoting sales." In each instance, there is a clear message that there will be "no termination except for good cause."

Promissory Estoppel

Such "promissory" or "equitable" estoppel has many variations and applies to numerous aspects of the franchise relationship. Most courts have recognized this by fending off technical and contrived defenses. The illustrations are quite informative. For example, in *Highland News*,[7] the court held that if the newspaper dealers could prove promissory, or equitable, estoppel based on oral statements and conduct, plus the anticipated reliance, a contract would exist. Massachusetts law would also preclude the publisher's reliance on the Statute of Frauds, grounded by the same estoppel on which the oral contract was based. As another corollary, the court held that summary judgment was inappropriate for the publisher's allegedly tortious interference with the newsdealers' contractual relations with their customers."

Estoppel is available for almost ev-

key technical defense. In *Mr. Donut*," a fast-food franchisee alleged deception in the franchisor's promised support in an undeveloped territory, and particularly that it would establish a regional supply center to reduce the dealer's high transportation costs. The franchisor kept promising performance that induced the franchisee to keep waiting. When suit ultimately ensued, the franchisor pleaded the time barrier of the Statute of Limitations. In reversing both the trial and intermediate appellate courts, the Arizona Supreme Court found an estoppel.

Acknowledging the imbalance in the parties' relationship," the court relied on the dealer's right to depend on his franchisor's string of oral promises both before and after execution of the franchise contract. It commented that it would be both socially and economically counterproductive to require the franchisee to commence litigation in the face of such constant assurances by the franchisor, at least until such time as it became clear that the franchisor would not perform. In a long-lasting franchise relationship, it is especially important to foster constructive dealings, rather than to allow one party to erect technical barriers to protect its non-performance.

Another line of defense is that the substantive parol evidence rule precludes all extrinsic evidence because of the "integration" clause. The argument is that, in the absence of ambiguity, such evidence is inadmissible to explain or control its terms. That rule has, at best, been held to refer only to evidence offered "to contradict the written terms." " The prevailing view, adopted by the Restatement (Second) of Contracts §214 (1981), is that "evidence of the contract negotiations and the circumstances of its execution are always admissible to show whether the contract was intended by the parties as an integrated (i.e. final) expression of the terms of their agreement or to show the uncertainties in the contract's application."

The evidence of such intent can be established where there were subjects that were matters of express concern or even oral agreement, but which were not addressed in the written agreement. In one case, the parties orally agreed that the written lease of computer agreement would not become operational until the successful completing of two test runs." In another case, the policy was corroborated by express testimony of the franchisor's marketing personnel." In addition to consideration of the context in which the agreement was executed, the intent or the meaning of specific terms can be established by business usage either in the particular industry or in the specific franchisor's business." The proposed interpretation may also be corroborated by the way in which the parties have in fact performed over a period of many years." The admissibility of such evidence is not dependent on a finding that the written agreement is ambiguous on its face. The "intent to integrate" is a question of fact for the jury.

'Doubtful' Applications

If the parties agree that the terms of a contract are apparently "clear and unambiguous," the court may still entertain extrinsic evidence where the factual application of the written agreement is in any respect uncertain or equivocal in its meaning. The doubts in the "application" of an agreement can often involve unanticipated issues which usually arise in a longterm relationship like a franchise." The consistent conduct of the parties may provide the best understanding of the meaning of the contract.

In a California case," the sales representative of a Japanese electronics manufacturer sold consumer electronics products under a written franchise terminable by either party on 30 days' notice. That agreement was executed in 1979, almost 10 years after the dealer had first become involved in the distribution system. Based on the parol evidence rule, the district court rejected all extrinsic evidence of prior oral assurances and granted summary judgment to the effect that the factory was not required to show "good cause" for termination. That ruling was reversed by the Ninth Circuit.

The evidence disclosed that in 1974 when the dealer had previously incorporated his sales company to handle Sanyo products, he had an express oral understanding that Sanyo would not terminate except for "poor performance uncorrected after notice" and that his tenure "would be for a longterm 'family' relationship comparable to arrangements that prevail in Japan." The same "understanding" also preceded a written 1976 dealer agreement with a closely related company, containing the same 30-day termination clause. The verbal assurances were then confirmed in later conversations with named officers. The same process was repeated in 1978. One witness testified that such an "understanding" prevailed in the consumer electronics industry for representatives of a Japanese related manufacturer. Substantial promotional expenditures were made in reliance on the dealer's understanding of "policy."

The Ninth Circuit held that this raised a factual question as to the proper interpretation of the express written agreement. The court "focused on the nature of the (dealership) and the importance of the longterm prospects to hold that the clause was reasonably susceptible to an interpretation requiring good cause for termination." It rejected the simplistic idea that in the absence of the phrase "for good cause," it is "presumed that the contract is terminable at will by either party." Rather than attempting "an oral modification of the written agreement," the dealer's claim was based on "the original meaning of that agreement, buttressed by the surrounding circumstances and the oral assurances." On remand, the court must still determine whether "good cause" did exist.

Fair Dealing

Almost by definition, when a franchisor declares that its policy is to treat its franchisees fairly, it has thereby provided a tangible formula for the obligation of "good faith and fair dealing." Its failure to adhere to that policy will therefore trigger a violation of that standard. It has been widely asserted that in every contract, each party is precluded from denying the other party the fruits of the contract, meaning that there is such an "implied covenant" of good faith and fair dealing."

The proposed Uniform Franchise and Business Opportunity Act was approved Aug. 7, 1987 by the National Conference of Commissioners on Uniform State Laws. (NCCUSL). The proposal would bar contractual waiver of guaranteed rights (§103) and preserve rights under other common or statutory law (§105). Its major flaw lies in the definition of the "duty of good faith," constituting a major retreat from judicial construction. Instead of the high standard implicit in the phrase, it adopts the diluted version employed in the Uniform Commercial Code (UCC) namely "(the duty) means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." In substance, if most franchisors treat their franchisees in a particular fashion, the "duty" of good faith will have been satisfied. This conflicts with existing common law."

The Texas Supreme Court has veered from an absolute implication of good faith and fair dealing in every contract." It has, however, left open the issue of an implied covenant in particular circumstances. It has since held that a duty of good faith and fair dealing does arise where there is a distinct imbalance in the relationship of the parties and that the "implied duty" cannot be waived." Due to the prevalent imbalance in almost every franchise relation, that principle would control, especially where the franchisee's investment is at the mercy of the franchisor." If the franchisor's conduct is contrary to its declared policy of fair dealing, the substantive violation seems clear." In these circumstances, the franchisor could not contractually deprive the franchisee of such protection."

"Little" FTC acts offer an ideal vehicle for franchising claims based on a franchisor's violation of its declared "policy." Where the state statute provides a private cause of action, it can be employed to enforce the policy "terms" of the FTC Franchise Presale Disclosure Rule." It may also be used to challenge both "deceptive" or "unfair" acts and practices involved in the sale of any business, as well as misconduct during and at the termination of the franchise. Since state courts are usually "guided" by federal precedents, a national body of franchise law will probably be developed through the application of the "little" FTC acts." Such relief is in addition to, and not an alternative to, traditional tort and contract remedies."

Strict Acts

The "little" FTC acts are particularly strict in their banning of "deceptive" acts or practices. The FTCA requires affirmative disclosure to a prospective franchisee of all material information that is relevant to his or her purchase of the franchise, including relevant policies." When a franchisor declares its fairness policies, but does not comply, there is strong indication of statutory deception. The phrase "deceptive acts or practices" has been quite liberally interpreted, making it much easier than proving common-law fraud.

Under "little" FTC acts, it is not necessary to prove that the franchisor "intended to deceive," or "knew" that its representations were false; even negligent misstatements are enough." A practice is deceptive if it could reasonably be found to have caused a person to act differently from the way he or she would otherwise have acted. The standard is whether the representations have the "tendency or capacity to deceive." Further, proof of actual or detrimental reliance is unnecessary." The

claimant need only show that the deception caused damage.

Massachusetts courts have adopted the original Federal Trade Commission three-part test to determine whether a practice is unfair, namely:

"1. whether the practice is within the penumbra of some common law, statutory or other concept of unfairness;

"2. whether it is immoral, unethical, oppressive or unscrupulous;

"3. whether it causes injury to consumers or other business persons or competitors." [9]

The Massachusetts Appeals Court interpreted the test to require that unfair conduct "must attain a level of rascality that would raise an eyebrow of someone inured to the rough and tumble of the world of commerce." [10]

Fee Charging

The Supreme Judicial Court found an "unfair practice" where a licensor required a minimum fee for the transfer of a tenancy in a mobile-home park.[11] In condemning "the charging of a fee for no service whatsoever," the court relied on a common law decision of the New Jersey Supreme Court holding invalid a contract in which "although the purchaser received something of value, the value received was unconscionably disproportionate to the price paid." [12] In such proceedings, the artfully drafted provision of the commercial agreement will provide little protection for the violator.

As the Massachusetts court noted: "The willingness of (mobile-home) tenants to pay resale fees and even to contract knowingly to pay those fees, does not make the collection of such a fee fair. It merely demonstrates the extent to which the defendants had their tenants at their mercy." The extraction of a resale fee for no services rendered in these circumstances, was an unfair act or practice under the "little" FTCA."

Where a franchisor fails to comply with its own declarations of policy, such conduct would therefore appear to constitute both an "unfair" and a "deceptive" act or practice under a "little" FTCA. Under Washington's "little" FTCA, a breach of the "obligation of good faith and fair dealing" is itself treated as a per se violation of that statute.[13] Whenever a franchisor declares its fairness policies, that standard must be treated as the "minimum" measure of its obligation to its franchisees under the statutory standard of "unfair acts or practices." As earlier noted, the franchisor cannot take away such rights by clever boilerplate contract clauses like "integration" or "nonwaiver." It also may not rely on defenses like the Statute of Frauds or the Statute of Limitations where their use would be "estopped."

The "little" FTCA is an attractive vehicle for a variety of reasons. Its coverage is extensive. It grants a private cause of action to those who have suffered a loss as a result of such unfair or deceptive practices. A successful plaintiff must be awarded his or her reasonable attorneys' fees. Furthermore, in the case of a willful or knowing violation, the court may assess against each violator an award of punitive damages or a statutory prescription of up to three, but not less than two, times the actual damages sustained, though the compensatory damages may only be collected once.[14]

Unlimited Declarations

There is no limit to the extent of a franchisor's policy declarations. While the illustration was confined to the issue of "termination for cause," it will include other capital matters such as renewal, transfer, or a public-stock issue. In operations, it would cover territorial integrity even where a nonexclusive grant were made. Another important matter is the setting of sales quotas and a process for their revision.[15] Advertising practices would cover accounting for use of proceeds, choice of advertising agency, selection of media, sites for placement, and cooperative dealer effort in local areas. While franchisors must comply with various pre-sale disclosure regulations, their sales presentations to prospective franchisees often consume two to four hours. During that time, the franchisor must cover a whole array of policy matters, explaining how the particular system operates. That sales presentation is therefore a primary source of enforceable "policy" statements.

In any case, a franchisor is under an affirmative duty of disclosure to prospective franchisees where it has an established policy. It must inform about territorial encroachment on existing dealers, including the percentage of probable impact that will prohibit any incursion. It must declare its policy on franchise renewals. It must express its policies on the approval of transfers and the circumstances under which it may exercise a contractual right of first refusal. It must reveal its policy regarding the grant of additional franchisees, with special emphasis on when a franchisee may be regarded as expandable. And it should clearly explain its default policies, such as making available a reasonable opportunity to cure after notice and even the grant of a decent opportunity for the defaulted franchisee to sell his or her franchised business at its going value, subject to the franchisor's reasonable right of approval of the proposed transferee." A franchisor cannot reasonably insist on concealing these vital policies, nor can it successfully claim immunity from accountability for their violation.

In spite of these policy developments, the Eighth Circuit Court of Appeals disregarded the importance of a policy declaration by a major fast-food franchisor.[16] Following its established policy, the franchisor gave the franchisee a three-year notice of its intent not to renew the 20-year franchise, but expressly offered the franchisee an opportunity to sell the franchise to an approvable buyer prior to the expiration of the term. Instead of enforcing that policy, the appellate court treated this vital matter like a simple contractual offer that was automatically rejected

when the franchisee made a counter proposal. The court thereby destroyed an intangible right that was worth several hundred thousand dollars. When the franchisee attempted to negotiate other terms, he obviously did not intend to surrender the opportunity to obtain fair market value for his existing business, nor should the appellate court have participated in his total forfeiture of a valuable business property.

Enforcement of declared policy will foreclose the persistent effort of franchisors to seek protection in artfully drawn franchise agreements presented to prospective franchisees on a "take-it-or-leave-it-basis." As noted, in such contracts of adhesion, the franchisor's contractual obligations are usually ill-defined or nonexistent, while those demanded from the franchisee are specific, persuasive, and impossible to satisfy in full. This imbalance is especially injurious in boilerplate integration and nonwaiver of default clauses. Under "little" FTC acts, there is grave doubt that such contractual defenses are available. It is against this background that enforcement of fairness policy will be acknowledged as the guiding standard in spite of seemingly contradicting contractual terms.

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(1) See Bus. Franch. Guide Para. 4,000 et seq. for a collection of such generic statutes. Many States also have enacted protection for franchisees in particular industries. In employment relations, many courts have held that "policy declarations" take precedence over "termination at will."

(2) See M.J. O'Hare, "Retroactive Application of State Franchise Termination Laws," 7 (No. 3) Franchise Law Journ. 3 (1988).

(3) *Miskimen v. The Kansas City Star Co.* 684 SW 2d 394 (Mo. App. 1984) (franchisor estopped to assert short-term right of termination "without cause").

(4) See, *e.g.* Miskimen, supra.

(5) It is reported that the class settlement exceeded $25 million.

(6) *Straup v. The Times Herald*, 283 Pa. Super. Ct. 58,423 A. 2d 718, (App. Div. Pa. Ct. of Comm. Pleas 1980) (promissory equitable estoppel); *Loranger Construction Co. v. E.F. Hauserman Co.* 376 Mass. 757, 384 NE 2d 176 (1978).

(7) See *Walker v. Kentucky Fried Chicken Corp.*, 728 F. 2d 1215 (8th Cir. 1984) (reliance must differ from preexisting contractual consideration.

(8) *Highland Neves Co., Inc. v. The Hearst Corp.*, Bus. Fran. Guide Para. 9623 (D. Mass. 1986).

(9) Id.

(10) See also *Albrecht v. Herald Co.*, 390 U.S. 145, 88 S.Ct. 869, 19 L. Ed. 2d 998 (1968), in which the publisher employed similar tactics to enforce a pricing violation.

(11) *Mr. Donut of America v. Dean Harris*, 723 P. 2d 670 (S.Ct. Ariz., 1986).

(12) The court cited the author's first book, "Franchising: Trap for the Trusting" (Little Brown & Co. 1969), at p. 41.

(13) See *Jack Rouse Assoc., Inc v. Fisher Corp.*, — F. 2d (9th Cir. 1987), (CCH) Bus. Franch. Guide Para. 9018. In Wisconsin, the appellate courts have held that where there is an integration clause in the franchise agreement, the parol evidence rule excludes all oral discussion and prior agreements. *Spahn Enterprises, Inc. v. Badger Northland, Inc.* Para. 9009 Bus. Franch. Guide (Wisc. Cir. Ct. 1987). The Wisconsin ruling is faulted by the estoppel argument since the franchisee is ignorant of the chance that such a technical defense may be used to preclude his reliance on his franchisor's representations.

(14) See *Wang Laboratories, Inc v. Docktor Pet Centers, Inc.*, 12 Mass. App. 213, 423 NE 2d 809 (App. Ct. 1981); *Fred S. James & Co. of New England, Inc v. Hoffman* 24 Mass. App. 160, 507 NE 2d 269 (App. Ct. 1987).

(15) See *Jack Rouse Associates, Inc.*, supra, n.13.

(16) Id. In the controlling California case of *Pacific Gas and Electric Co v. G W Thomas Draying and Rigging Co.*, 69 Cal. 2d 33, at 37, 69 Cal Reptr. at 561, 364, 443 P. 2d 641 at 644 (1968), the court said: "The issue is not whether the [written instrument] appears to the court to be plain and unambiguous on its face, but whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible." In applying that test to a franchise agreement (*Sherman v. Mutual Benefit Life Ins Co.*, 633 F 2d 782 (9th Cir. 1980), the court focused on the nature of the position and the importance of the long-term prospects to (the agent) to hold that the clause was reasonably susceptible to an interpretation requiring good cause for termination. (Id. 633 F. 2d at 784-85). In *Rouse* (n.13, supra), the court allowed the interpretation that the 30-day termination clause required "good cause," given the factory's oral assurances and the circumstances surrounding the making of the agreement.

(17) See *Keating v. Stadium Management Corp.*, 24 Mass. App. 266, 508, NE 2d 123 (App. Ct. 1987) (reliance on parties' uniform practice for many years, until successor assumed the contract and then unilaterally changed the long-standing practice)

(18) See *Miskimen*, supra, where the practices had lasted for decades prior to the recent sale of the newspaper.

(19) See *Jack Rouse*, supra n.13.

(20) See, 11 Williston on Contracts, §1295 (3d ed. 1968); Burton, *Breachof Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 189 (1980); *Gram v. Liberty Mutual Ins. Co.*, 429 NE 2d 21 (Mass. 1981); *Druker v. Wilkens Jutras Associates, Inc.*, 370 Mass. 353, 348 NE 2d 763 (1976).

(21) *Slatkey v. Amoco Oil Co.*, 830 F. 2d 476, CCH Bus. Franch. Guide Para. 8459 (3d Cir. 1987) (en banc) (requiring "objective good faith" in determining whether distributor has made "bona fide offer" to sell leased premises to franchisee under the federal Petroleum Marketing Practices Act).

(22) *Manges v. Guerra*, 673 SW 2d 180 (Texas 1984).

(23) *Glen Arnold v. National County Mutual Fire Insurance Co.*, 80 Texas Sup. Ct. 177 (1987).

(24) See text for quotation from *Miskimen*, supra at n.3; *Glen Arnold*, n.23.

(25) *Cf Rosell, Inc v. McDonald's Corp.*, OCH Bus. Franch. Guide, Para. 8870 (D. Neb. 1986) *aff'd sub nom Schupack v. McDonald's Corp.*, OCH Bus. Franch. Guide, Para. 8871 (8th Cir. 1987).

(26) *Christensen v. Integrity Insurance Co.*, 709 SW 2d 734 (Tex. App. Houston [14th Dist. 1986]); *Beaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 545 Cal. 3d 782, 686 P. 2d 1188 (1984).

(27) and See *Bailey Employment Systems, Inc. v. Hahn*, 550 F. 2d 473 (2d Cir. 1981), on remand 545 F. Supp. 62 (D. Conn. 1982), aff'd per curiam in an unpublished opinion (2d Cir. 1983); contra, *LeBlanc v. Bell Center, Inc.*, (CCH Bus. Franch. Guide Para. 8971 (La. Ct.App. 1987).

(28) *Bailey*, supra n.27.

(29) See *Linthicum v. Archambault*, 398 NE 2d 683 (Mass. 1979) (additionally available for intentional warranty breach by roofing contractor.) See also, *Singleton v. Pennington*, 566 SW 2d 383 (Tex. Civ. App. 1978), in which the court characterized the Texas Deceptive Trade Practices Act as, "probably the most far-reaching legislation that has been enacted in Texas since the adoption of the English common law in 1846." 566 SW 2d at 386. In *Hinchcliffe v. American Motors Corp.*, 440 A. 2d 810 (Conn. 1981), the Connecticut Supreme Court described that state's statute as "proscribing] a broader range of conduct than did the common law for innocent misrepresentations. For the plaintiff victimized by such conduct, [the statute] provides an action more flexible and a remedy more complete than did the common law."

(30) See *Bailey Employment Systems, Inc.*, supra, no. 28.

(31) *MacGillivery v. W Dana Bartlett Ins Agency*, 436 NE 2d 964 (Mass. App. 1982) (applying Mass. c. 93A to negligent misrepresentations). An excellent example of the distinction between 'fraud' and 'deceptive practices' is found in *Bailey Employment Systems, Inc. v. Hahn*, 550 F. 2d 473 (2d Cir. 1981), on remand, 545 F. Supp. 62 (D. Conn. 1982). Although the District Court found no common law fraud at the first trial, on remand it found extensive 'deception and concealment' under the Connecticut "Little" FTC Act.

(32) *Nei v. Burley*, 388 Mass. 307, 446 NE 2d 674 (1983).

(33) *P.M.F. Associates Inc. v. Globe Newspaper Co.*, 366 Mass. 593, 321 NE 2d 915, (1975). The Attorney General regulations adopt this standard for the purpose of determining whether conduct is unfair or deceptive. 940 CMR §3.00. One of these regulations provides that "an act or practice is a violation of Chapter 93A, §2 if . . . [it] violates the Federal Trade Commission Act . . ." 940 CMR §3.16(4). The regulations are applicable to both §9 (consumers) and §11 (businessman) cases under Chapter 93A. *Linthicum v. Archambault*, 398 NE 2d 482, 487 (Mass. 1979).

(34) *Levings v. Forbes and Wallace, Inc.*, 8 Mass. App. 498, 396 N.E.2d 149, 153 (1979).

(35) *Commonwealth of Massachusetts v. DeCoto*, 316 NE 2d 748 (Mass. 1974).

(36) *Kugler v. Romain*, 58 N.J. 522, 279 A. 2d 640 (1971).

(37) See also *Fortune v. National Cash Register Co.*, 364 NE 2d 1251 (Mass. 1977) (employee not bound by a general release causing loss of sales commissions).

(38) *Salois v. Mutual of Omaha Insurance Company* 90 Wash. 2d 353, 581 P. 2d 1349 (1978) (en banc).

(39) See *Bailey*, n.28, supra; for statutory formula, see Mass. G.L. c93A, §§9 and 11, *International Fidelity Ins Co. v. Wilson*, 387 Mass. 841, 443, NE 2d 1308 (1983) (multiple defendants held independently liable for multiple damages under M.G.L. c.93A, subject to single collection of compensatory portion of judgment).

(40) *Cf. Richard Wholesale Liquors v. Glenmore Distilleries Co.*, (CCH) Bus. Franch. Guide Para. 9917 (4th Cir. 1987) (like Washington's "little" FTCA, the South Carolina statute requires proof of "impact on the public interest," beyond its merely "affecting the parties to a commercial transaction.") Such a restriction does not appear in most "little" FTC acts nor does it derive from FTC precedents.

(41) This "policy" has been adopted by some leading franchisors. By providing franchisees with a reasonable opportunity to obtain the fair market value of the franchised business, a franchisor can more freely exercise disciplinary controls throughout the entire franchise system.

(42) See *Rosell, Inc. v. McDonald's Corp.*, OCH Bus. Franch. Guide, Para. 8870 (D. Neb. 1986) *aff'd sub nom Schupack v. McDonald's Corp.*, OCH Bus. Franch. Guide, Para. 8871 (8th Cir. 1987).

Harold Brown is senior partner of the Boston firm known as the Law Offices of Harold Brown, and author of a revised edition of "Franchising: Realities and Remedies" published by the *Law Journal* Press.

The Numbers Game

The sale of franchises is still imbued with many facets of the "numbers game." On Oct. 30, 1987, the Federal Trade Commission entered a consent decree in Philadelphia, obtaining $50,000 in civil penalties against the two principal promoters of a now-defunct franchisor. The company sold self-service, shoe-store franchises to buyers who invested $75,000 for the franchise and initial inventory.[1] The respondents violated the "earnings' claim" portion of the FTC Presale Franchise Disclosure Rule by failing to give potential investors important information about likely results, after representing that each could expect annual profits of at least $75,000. The respondents also conceded false and deceptive claims "such as promising to help franchisees select retail sites; to provide training in management, marketing, and merchandising; and to supply adequate shoe inventories" for the discount operations.

Although the franchisor was another of the insolvent respondents "whose telephones were already disconnected," the case is significant partly for its re-emphasizing the import of the "earnings claims" portion of the FTC rule, triggered by the oral earnings claims. More important, it also focused on the elements of "false and deceptive" acts generally prohibited under §5(a) of the FTC act.

False, Deceptive Claims

There has been a tendency to ignore the violation based on site selection, training, marketing, and merchandising, and adequate sources of inventory supplies. Although these substantive failings often exist, it has been felt that courts are unlikely to venture into such subject matters due to their lack of ability to judge the quality and quantity of these elements. That is unfortunate, since these are the vital elements sought by every prospective franchisee in his purchase of the franchisor's "know how," coupled with a service-mark of acknowledged value.

In that respect, all FTC precedents will provide an important "guide" for courts in private litigation under little FTC acts. While government consent decrees do not constitute binding precedent for private enforcement under the antitrust laws, state courts have not displayed such reticence in relying on commission activity under the act. By far the greatest amount of FTC rulings has occurred through cease and desist orders that require independent approval by the commissioners. State courts have therefore accepted such precedents for guidance under the "little" FTC acts.

While declining under the Massachusetts "little" FTC act to compel a metropolitan newspaper to accept advertising by a dating service, the Supreme Judicial Court expressly relied on an absence of any FTC precedent, going so far as to examine staff opinions that had been published with commission approval.[2] Similarly, with appellate confirmation, a Connecticut district court based its interpretation of the state's "little FTC act on the principles of the subsequently adopted FTC Franchise Rule, thereby sidestepping the question of retroactive application of the disclosure regulation.[3] Further, in directing the district court to ignore the conflict of law question as to whether the Massachusetts or the Connecticut "little" FTCA applied, the Second Circuit Court of Appeals stated that they were identical. It expressly called upon trial courts to seek "guidance" from state court decisions in jurisdictions all over the United States. Such a salutary cross-discipline was felt to be justified by the need for uniform national interpretation as legislatively directed where state statutes expressly stressed reliance on federal sources.

Franchise Rule Compliance

While FTC enforcement of its Franchise Rule has not been earth-shaking, the agency has displayed an increasing determination to achieve compliance. In the *Amway* case,[4] the commission obtained a $100,000 civil penalty against one of the nation's largest franchisors of distributors who sell to other distributors or to members of the general public. Amway sells door to door home care, car care, and personal care products, vitamins, food supplements, and an array of other merchandise including clothing, household appliances, furnishings, tools, luggage, watches, and cameras. The proceeding was based on the respondent's violation of the commission's 1979 cease and desist order. The charges emanated from the "earnings claims" portion of the Franchise Rule. The FTC asserted that the company's newspaper advertisements contained earnings and sales claims that were "higher than the average for all dealers in any specified recent year, without disclosure of actual averages and the percentage of those that achieved the stated profits, earnings, or sales." That standard is fair and absolutely essential in order to prevent misleading enticement.

A very significant aspect of this challenge to such a major marketing entity is the fact that the "trigger" that activated the "earnings claims" portion of the Franchise Rule was the rather ordinary kind of lure based on profitability. Almost identical language can be found in hundreds of franchise advertisements that regularly appear in the *Wall St. Journal*, *The New York Times*, and other major, national media. Quite appropriately, such reputable journals declare they are unable to police their "business opportunity" advertisers in order to enforce the FTC's Franchise Rule. On the other hand, there is ample precedent for them to decline to publish advertisements with offensive "copy" that violates a national statute. Such violations can lead to heavy FTC civil fines, plus private enforcement under state statutes with the availability of class certification.[5]

'Very Sobering' Terms

There is more in the FTC enforcement record to prove that it has not receded to its historic status as the "little old lady at the corner of Pennsylvania and Constitution Avenues." Some have called its latest venture "the most important court action taken by the commission since the Franchise Rule became effective on Oct. 21, 1979, describing the allegations and proposed terms of the settlement as "very sobering."[6] In *Comprehensive Accounting Corp.*[7] the FTC sued one of the largest and most visible franchisors in the franchising world.

Focusing on misstatements of the average earnings and profits of existing franchisees, the FTC charged that Comprehensive Accounting did not disclose whether such franchisees "had contractual arrangements substantially the same as those being offered to new franchisees;" that fixed earnings averages were calculated through the use of "improper accounting methods," and that the "sample group" that was employed to derive earnings and profits history, had in fact excluded franchisees

who were no longer in the system. These serious and deliberate manipulations of the financial summaries were allegedly used as the basis for erroneous statements in newspaper advertisements, promotional materials, video tapes, and film strips. There were allegations of erroneous statements as to the number of former franchisees, that Comprehensive lacked a "reasonable basis" for its earnings claims, and that it "intimidated" existing franchisees who gave "poor or marginal references" to prospective franchisees.

Comprehensive Accounting has apparently agreed to a proposed consent decree, starting with payment to present and former franchisees of up to $3.5 million. The program of redress is rather unique, providing franchisees with 25 percent of their original franchise fee, forgiveness of outstanding indebtedness, and latitude for existing franchisees to renegotiate their franchise agreements. The prophylactic portion of the decree will require Comprehensive Accounting "to have a reasonable basis for its earnings claims"; to use generally accepted accounting principles in preparing earnings data; and to cease wrongful discouragement of franchisees who give poor references to prospective dealers. The irony of the case is that the Comprehensive Accounting franchise system does in fact license "accounting services" which it professes are of the "highest professional standards." Under the FTC Franchise Rule and state disclosure statutes, Comprehensive Accounting must hereafter report this controversy and settlement decree to all prospective franchisees.

Earnings Claim Defined

With the growing severity of governmental challenges to "earnings claims," franchisors are appropriately concerned with the means available to proceed constructively with the development of a franchise system without subjecting themselves to excessive exposure. In general, both federal and state regulators have provided a basic "safe harbor" so long as no such claim is made. General reliance is placed in the FTC rule's definition of "earnings claim" as

"Any oral, written, or visual representation to a prospective franchisee or for general dissemination in the media which states or suggests a specific level or range of potential or actual sales, income, or gross or net profits."

The triggering device can be (1) report of actual historical performance, (2) forecasts and projections, (3) pro formas, (4) suggested achievement levels, (5) data on which interpolations can be based, or (6) illustrative charts or arithmetic tables. Devious means will not succeed in avoiding the implementation of the FTC "earnings claim" rule. Such ruses include the referring of prospective franchisees to specific franchisees or other sources from which the data is obtainable. In a large fastfood franchise, the franchisor's marketing personnel expressly state that they are not allowed to make any earnings statements. They then encourage the prospect to prepare his own estimates for oral comparison and "adjustment" to the franchisor's "undisclosed" computations. Such sham devices fail, but they will increase the probability of exemplary or punitive damages under the statutory or common law.

It has been both cumbersome and expensive for franchisors to satisfy the "earnings" disclosure requirements of the 15 states with "registration and prospectus" statutes. The Uniform Franchise Offering Circular (UFOC) of the North American Securities Administrators' Association (NASAA) has gone far to aid in facilitating uniformity, but at a price regarded as excessive by numerous franchisors. Generally, no disclosures can be made in the absence of a prior operating history, thus crippling entry by new franchisors. Under the FTC rule, the specifications for earnings claims are substantial, but they allow a greater degree of reliance on "reasonable" bases for the data and the methods of preparation. In spite of this, large numbers of franchisors have sought to avoid compliance by expressly denying that they offer any such data or projections.

Such conduct is self-defeating since it obviously lessens the franchisor's ability to market its franchises, while depriving prospective franchisees of vital data needed in their making an important decision. In fact, without such assurance, only a fool would pay thousands for a franchise, then invest tens of thousands in the plant, equipment, and inventory necessary to make it operate.

Impact of Stalemate

The stalemate has seriously impacted prospective franchisees and their franchisors. In order to address that need, NASAA has produced a revised version of Items 19 and 20 of the UFOC. The proposal was "adopted" by NASAA in November, 1986. Since NASAA is only an unofficial organization, the proposal is entirely dependent on approval by individual states. Actual adoption has occurred only in Illinois and Michigan, with informal adoption or the process of consideration in six states (Indiana, N. Dakota, S. Dakota, California, Washington, Wisconsin), and no action at all in the remaining seven states (Hawaii, Maryland, Minnesota, New York, Oregon, Rhode Island, and Virginia). At the federal level, the FTC approved the alternative UFOC for permissive use until the end of 1988 and for mandatory use commencing Jan. 1, 1989.

While this indicates an eventual approach to uniformity, the interim confusion is serious. At the state level, there is a "moving target" with little or no assurance of legislative action by 13 states. As for the FTC, its original rule has allowed compliance by use of any State disclosure regulation that is equally as protective as the FTC rule, so long as the state disclosure is used in its entirety in the state where the new franchise is to be located. The phrase "equally protective" is not self-operating, leaving it open to argument as to each individual state.

At least until Jan. 1, 1989, there are four alternative plans, providing confusion for the prospective franchisee and his counselors, while failing to relieve the cost and delay for franchisors. The Franchise Committee of NASAA may be able to lessen the confusion by eliminating one of the duplicate versions of Item 19." But even if it does so, its action will only be effective in a small portion of the 15 states with "registration prospectus" statutes.

Revised Item 19

The new Item 19 eliminates much of the complexity of the original Item 19. It does not state a specific disclosure format nor identify specific information which must be disclosed. The phrase "earnings claim" is defined in the instructions for the new UFOC Item 19 as:

"Information given to a prospective franchisee by, on behalf of, or at the direction of, the franchisor or its agent, from which a specific level or range of actual or potential sales, costs, income or profit from franchised or non-franchised units may be easily ascertained."

The accompanying instructions also declare that "hypothetical claims," such as charts, tables, and mathematical formulae, are subject to Item 19. While "earnings claims" are not required to be used, when they are in fact employed, they must be included in the offering circular. The two exceptions are historical data of "actual operating results of specific units" in connection with an offering to sell that specific unit. The second exception is the use of a "supplemental earnings claim" for a "specific situation," provided that it is given in writing, with an explanation of any departure from the offering circular, with preparation in accordance with new Item 19, and then delivered and left with the prospective franchisee.

The actual substance of new Item 19 is quite simple in its words. "Earnings Claims" that have to be included in the offering circular must satisfy the broad requirement that they were made," with no specific definition of the meaning of that phrase. New item 19 B adds, "An earnings claim shall include a description of its factual basis and the material assumptions underlying its preparation and presentation." " Based on the belief that franchisors would have better access to the information and the expertise needed to formulate what is "reasonable," the ultimate burden of proof is placed on the particular franchisor to demonstrate: (1) what constituted the basis for an earnings claim; and (2) that the basis was reasonable at the time the claim was made. Both "forecasts" and "projections" can be employed when they meet the express standards of the American Institute of Certified Public Accountants, Inc., similar to the standard used in stock prospecti.

The very simplicity of new Item 19 may explain why only a small portion of the affected states appear to be ready to adopt new Item 19, while half of them have neither taken action nor are even considering them. Their skepticism may be rooted in the historical record of inadequate "earnings disclosures" by franchisors, plus the extreme importance of meaningful data for the prospective franchisee to use in making a "once-in-a-lifetime" business decision. Even with the simplified new Item 19, franchisors are engaged in broad-based efforts to repeal the extensive array of state legislation that was adopted in the past two decades in order to counteract the gross imbalance that prevails in the franchise relationship both at its inception and during the many years of its existence.

For example, after five years of gestation, a proposed "Uniform Franchise and Business Opportunities Act" was adopted in August 1987 by the National Conference of Commissioners on Uniform State Laws (NCCUSL)." That much revised proposal contains articles that have been severely criticized." The general standard of a "duty of good faith and fair dealing" is severely cut back by defining it in commercial-law usage and then restricting it to the express terms of the particular franchise agreement.

This proposal is directly contrary to the *en banc* ruling of the Third Circuit Court of Appeals in its interpretation of the "bona fide" standard imposed on major oil companies in the federal Petroleum Marketing Practices Act.[1] In *Slatky*, the full *banc* of the circuit court rejected the "subjective" form of good faith for the oil company's method of determining the price at which it would offer the service station site to the terminated dealer, as well as the actual offering price that was so determined. In opting for objectivity, the majority of the *banc* affirmed that the phrase did not condone conduct that was "adopted in a commercially reasonable manner" (as allowed in the UCC) nor simply because it conformed with the franchise contract.

Artfully drawn franchise agreements do not bear a good reputation for fair dealing. They have spread the seed for firm statutory measures all of which would be repealed wherever the "Uniform Laws" proposal is adopted. The second portion simply echoes the federal and state presale disclosure regulations by incorporating them by reference, thereby adding nothing. The third section sets up elaborate presale disclosure regulations for the sale of "nonfranchise" business opportunities, an area in which most states currently forbid such fraudulent schemes and have no need to create an administrative hierarchy for the handling of such disclosure matters.

Proposal Is Inadequate

The inadequacy of the NCCUSL proposal is highlighted by the already declared opposition of the Franchise and Business Opportunities Committee of the NASAA. The opposition of that group is formidable since it emanates from the combined wisdom of the 15 states that have been administering franchise "registration-disclosure" statutes and regulations for close to twenty years. In spite of their very extensive daily confrontation with franchise problems, that group was neither invited nor did it participate in the "uniform law" proceedings. Franchisee groups and other experts were similarly uninvited. The drafting committee was, however, carefully guided by the full time membership and presence of several official past and present spokespersons for franchisor associations.

One FTC commissioner has started informal consideration of a plan to give the FTC disclosure requirements preemption over all state disclosure statutes, without assuring that franchisees will retain their private right of action for violations. That commissioner has met with an informal group of franchisor representatives whose effort is directed toward wiping out all 15 state presale disclosure statutes and their enforcement mechanisms. There are substantial advantages in uniformity both for franchisors and franchisees, including worthwhile savings for compliance. There may, however, be serious problems involving the power of such preemption without congressional approval, the risk of concentrating such responsibilities in a federal agency of limited size and commitment, the displacement of important state administration and enforcement functions, and the lack of implementation of private enforcement rights that have been rejected by the courts in spite of express recommendation by the FTC when it adopted its rule.

The "numbers game" is thus seen as neither a "game" nor a "numbers" arena for accountants and actuaries. It is the focal point of an everlasting balancing of divergent interests. Franchisors have a need for "uniformity" that can simplify the task of adequate presale disclosure to prospective franchisees. They want to avoid disclosures that will expose them to civil penalties and fines by federal and state administrators as well as to private enforcement by the many franchisees who can prove that they were deceived in the purchase of a franchise. Such legal recourse derives not only from common law fraud, but also from statutory remedies like the "little" FTCAs, the state registration statutes, and both federal and state RICO enactments relying on a pattern of mail or wire fraud.

The fact is that honest and fair-minded franchisors are surviving quite well under the existing presale disclosure regulations. Hundreds of federal and state representatives have conducted extensive committee and legislative proceedings that have resulted in a bona fide effort to make the system work. It is, however, evident that skilled and highly paid agents for certain franchisors have found a fertile field in seeking to accomplish through lobbying efforts what they have been unable to secure through judicial proceedings under prevailing laws. That is what the "numbers game" is all about.

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(1) See *FTC v. Lady Foot International, Inc et al*, Civ. No. 87-6929, entered Oct. 30, 1987, E.D. Pa.

(2) See, e.g. Mass G. L. c 93A, sec. 2a, codifying sec. 5(a) of the FTCA and directing the state courts to be "guided" by the interpretations given by federal administrative agencies and courts.

(3) See *PMP Associates, Inc v. Globe Newspaper Co.*, 366 Mass. 593, 321 N.E.2d 915 (1975).

(4) See *Bailey Employment Systems Co. v. Hahn*, 633 F.2d 473 (2d Cir. 1981), on remand, 545 F.Supp. 62 (D. Conn. 1982), aff'd in an unpublished per curiam opinion by the Second Circuit, Feb. 17, 1983, in which the district court applied the Connecticut Unfair Trade Practices Act.

(5) *Id.*

(6) *U.S. v. Amway Corporation*, (D.D.C. 1986), 30 (BNA) ATRR 907.

(7) See n. 3, *supra*.

(8) See *Dollar Systems Inc. v. Avcar Leasing Systems Inc.*, (CCH) Bus. Franch. Guide Para. ¶ 8934 and 8935 (C.D. Cal. 1987); ($715,000 restitutionary award plus allowance for attorneys' fees for two auto rental franchisors where franchisor failed to register before offering franchises in Maryland and Virginia, thereby violating their registration laws and that of California, plus the FTC pre-sale disclosure requirements. Both franchisor and its two officers and directors were held jointly and severally liable).

(9) *U.S. v. Comprehensive Accounting Corp.*, Civ. Action No. 87C6874, filed Aug. 5, 1987 in the N.D. Ill.

(10) In late August 1987, the Franchise and Business Opportunity Committee chairperson advised NASAA that its current program will be directed toward deleting portions of the UFOC that have been adopted, but not much used, such as the multiple items 19 and 20.

(11) For new item 19 of the UFOC including the Accompanying Instructions, see (CCH) Bus. Franch. Guide Para. 5819 and particularly the definition of "Earnings Claim" in Instructions (1).

(12) Id.

(13) Although the proposed uniform law was approved in August 1987 by the National Conference of Commissioners on Uniform State Laws, the finished version is not yet available for examination, since the drafting committee was requested to "polish up the language."

(14) See H. Brown, "Proposed Uniform Franchise, Business Opportunities Act," N.Y.L.J. Dec. 15, 1986, p. 1.

(15) See *Slatky v. Amoco Oil Co.*, ___ F.2d ___ (3rd Cir. 1987) (en banc), (CCH) Bus. Franch. Guide Para. 8959.

Harold Brown is senior partner of the Boston firm known as the Law Offices of Harold Brown, and author of a revised edition of "Franchising: Realities and Remedies" published by the *Law Journal Press*.

Fair Franchising Coalition
1725 K Street, N.W.
Suite 308
Washington, DC 20006

Telephone: (202) 775-1135
Facsimile: (202) 785-1978

August 9, 1988

Ms. Phyllis Woodford
House Small Business Subcommittee
on Antitrust, Deregulation and Privatization
B-363 Rayburn HOB
Washington, DC 20515

Dear Ms. Woodford:

First, I'd like to express our thanks for the opportunity to present our views at the subcommittee's hearing August 4 on franchising issues. The hard work and preparation of the past months clearly paid off in a hearing that demonstrated divergent views on a complex subject.

Secondly, with regard to a specific point raised at the hearing. I have enclosed some additional information for the subcommittee's use. At the August 4 hearing the Wisconsin Franchise Act was mentioned a number of times. After the Act was approved, it was the subject of fairly extensive attacks by franchisor interests, including the International Franchise Association. The Wisconsin Legislature then held hearings on whether the Act should be changed at the request of the International Franchise Association. The enclosed Final Report of the Committee basically states that the Franchise Act has not hindered growth in franchising or affected profitability. Therefore, the Committee unanimously recommended that the Wisconsin Franchise Act not be modified.

I suggest that this report be included in the printed record of the hearing. Please let me know if I may be of any further assistance.

Thanks again for your interest and congratulations to you and Chairman Eckart on a successful effort.

Sincerely,

Chris Burke

Christopher J. Burke
Washington Activist

Final Report

February 1985

Committee on Economic
Development Subcommittee
on
Franchise Laws

G. Spencer Coggs

State Representative

CHAIRMAN
Committee on Urban and Local Affairs
VICE-CHAIRMAN
Assembly Democratic Caucus
MEMBER
Committee on Economic Development
Committee on State Affairs
Committee on Rules
Committee on Elections

Assembly Committee on
Economic Development

Report of The Subcommittee
on Franchise Laws
Rep. Spencer Coggs, Chairperson

At the request of representatives of certain business franchises doing business in Wisconsin who are members of the International Franchise Association (IFA), the Subcommittee on Franchise Laws was created in October 1983. The Subcommittee was directed to determine whether Chapter 135 of the Statutes, "The Wisconsin Fair Dealership Law", and Chapter 553 of the Statutes, "The Wisconsin Franchise Investment Law", contained restrictive provisions which hindered the State's economic development by creating disincentives for business franchisors to operate or expand their business activities in Wisconsin.

Of particular concern to members of the IFA were ss. 135.03 and 135.04 of the Fair Dealership Law, which provide that:

Home Address: 3761 N. 24th Street, Milwaukee, WI 53206 • (414) 442-0739
Capitol Address: Room 108 North, State Capitol, P.O. Box 8952, Madison, WI 53708 • (608) 266-5580
Legislative Hotline: Toll-free message service • 1-800-362-9696

135.03 Cancellation and alteration of Dealerships. No grantor, directly or through any officer, agent or employe, may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. The burden of proving good cause is on the grantor.

135.04 Notice of termination or change in dealerships. Except as provided in this section, a grantor shall provide a dealer at least 90 days' prior written notice of termination, cancellation, nonrenewal or substantial change in competitive circumstances and shall provide that the dealer has 60 days in which to rectify any claimed deficiency. If the deficiency is rectified within 60 days the notice shall be void. The notice provisions of this section shall not apply if the reason for termination, cancellation, or nonrenewal is insolvency, the occurrence of an assignment for the benefit of creditors or bankruptcy. If the reason for termination, cancellation, nonrenewal or substantial change in competitive circumstances is nonpayment of sums due under the dealership, the dealer shall be entitled to written notice of such default, and shall have 10 days in which to remedy such default from the date of delivery or posting of such notice.

Although these provisions were originally enacted by the 1973 Legislature to protect business franchisees and dealers from the arbitrary and capricious termination of their franchises and dealerships without cause and with little or no advance notice, there is some belief that these statutory provisions make it difficult, if not impossible, to terminate a franchisee who fails or refuses to comply with essential and reasonable requirements contained in the franchise agreement. As a result, it is claimed that new business franchisors are reluctant to expand into Wisconsin and established businesses are hesitant to expand their Wisconsin franchise operations.

The Subcommittee on Franchise Laws conducted three public hearings on the following dates:

November 15, 1983 (Madison)
November 21, 1983 (Milwaukee)
December 6, 1983 (Madison)

At these public hearings, the following persons presented testimony:

(1.) November 15, 1983 Public Hearing
Andrew A. Caffey, International Franchise Assoc. Washington D.C.
Andrew Kostecha, U.S. Dept. of Commerce Washington D.C.
Tom Coenen, Retail Gasoline Dealers Assoc. McFarland, Wisconsin
William F. Nelson, Wisconsin Business and Industry Improvement Council, Madison

(2.) November 21, 1983 Public Hearing
Jeffrey Steven, Wisconsin Restaurant Assoc. Shorewood
Gary L. Antoniewicz, Wisconsin Farm Equipment Assoc., Madison
Eldon H. Roesler, Wisconsin Feed, Seed & Farm Supply Assoc., Nashotah
Andrew A. Caffey, Internation Franchise Assoc. Washington D.C.
Attorney James S. Grodin, Milwaukee
Attorney Alan H. Deutch, Milwaukee
Bob Long, Pizza Slices Inc., Brookfield
Alan E. Kerpadz, Office of the Commissioner of Securities, Madison
Steve Janecko, Pizza Slices, Inc., Brookfield
Tony Oriesson, International Franchise Assoc.
Attorney Peter Stone, Milwaukee
Tom Coenen, Retail Gasoline Dealers Assoc. of Wisconsin, McFarland

(3.) December 6, 1983 Public Hearing
John M. Tifford, Federal Trade Commission, Washington D.C.
Joe Wisniewski, Wisconsin Restaurant Assoc. Madison
Rudolph F. Regez, Swiss Colony Stores, Inc. Monroe
Jeffrey Steven, Shorewood
Bruce J. Charles, White Hen Pantry, Milwaukee
Mike Hasburgh, Mike's Farm Equipment, Blanchardville
Steve Janecko, Pizza Slices Inc., Brookfield
David E. Lasky, Breslers 33 Flavors, Inc. Arlington Heights, Illinois
Gary L. Antoniewicz, Wisconsin Farm Equipment Assoc., Madison

James J. Walz, White Hen Pantry, Milwaukee
Charles Werve, Wisconsin Business and Industry Improvement Council, Madison

At each of the three public hearings, testimony was presented to the effect that Wisconsin's Fair Dealership Law made the state a less desirable location for the development of new business franchises and the expansion of franchise operations generally. Also, some testimony indicated that in isolated instances, certain franchisors were curtailing their Wiscosnin operations due to the restrictions contained in the law.

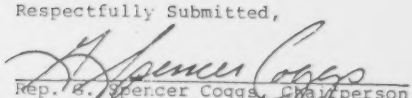
However, the great majority of persons who testified favored retention of the Fair Dealership Law without change, indicating that the "due process" requirements of the law provided necessary protections for franchisees and that business franchising in Wisconsin remains "alive and well" despite the law's existence.

Also, the Subcommittee was not presented with any tangible evidence that present state law has been an impediment to economic development in Wisconsin. In fact, in response to a request from Subcommittee member Rep. Mary E. Panzer for documentation on the level of franchising in Wisconsin compared to other states, Mr. Andrew Caffey, IFA General Counsel, in a November 30, 1983 letter to Rep. Panzer, stated that after reviewing a U.S. Department of Commerce publication detailing the number of business franchises in each state on an industry-by-industry basis, his organization had "extreme difficulty drawing any preliminary statistical conclusions from the data".

Absent any concrete evidence that existing state law has materially hindered the growth of business franchising in

Wisconsin or has eroded the profitability to franchisors of their existing franchises in this State, it is the unanimous (6-0) recommendation of the Subcommittee on Franchise Laws that: (1) Chapter 135, Statutes, "The Wisconsin Fair Dealership Law", should be retained without change; and that (2) Business franchises subject to state regulation under Chapter 553, Statutes, "The Wisconsin Franchise Investment Law", should not be made exempt from the provisions of Chapter 135. Additionally, it is recommended that if substantial interest is again generated concerning a change in Wisconsin's Franchise Law, a similar subcommittee is the proper vehicle to adequately address the vast scope of this issue.

Respectfully Submitted,



Rep. R. Spencer Coggs, Chairperson
Subcommittee on Franchise Laws